LITERATURE REVIEW OF THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN A TURBULENT ECONOMIC ENVIRONMENT

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ABSTRACT

This theoretical study sought to investigate the effect of corporate governance on the financial performance of commercial banks in a turbulent economic and political environment. A lot of studies in corporate governance and firm performance have focused mainly on the manufacturing and other sectors with the exclusion of the financial. The current study focuses on this neglected sector in the assessment of the effect of corporate governance on performance of commercial banks in a turbulent economic and political environment. The results from the investigation indicate that the rights of shareholders, transparency and disclosure and board operation enhance performance and eventually improve shareholders' value. The results of the research give a strong support to the idea that good governance framework is crucial in the financial sector as it positively influences firm performance. The desktop study also reveals that during times of high political volatility, the board of directors could try to make profit maximization the main goal in order to drive the bank towards making profits as the chances of making losses will be very high. This comes from the fact that the board is expected to manage all the bank's forms of risks, through both the risk management committee and the audit committee. The study scrutinized the effect of corporate governance on the performance of commercial banks. It is evident that corporate governance performs a major function in the overall growth and success of banks. The findings of this study advocate and support good corporate governance practices in commercial banks as a tool of curbing bank collapsing.

Keywords: Corporate Governance, Financial Performance, Turbulent Economic Environment, Developing Country, Literature Review.

INTRODUCTION

The effect of corporate governance on firm performance remains a very topical issue the world over, Africa included. Notable studies (Drakos & Bekiris, 2010; Abdullah et al. (2014); Ogege & Boloupremo, (2014); Adam (2014) and Adebayo (2013) submitted that there was a positive relationship between corporate governance variables, being number of directors, inclusion of non-executive directors, and presence of women directors, CEO duality and firm performance. However, Adegbite et al. (2012); Adolph (2013); Fernández Méndez et al. (2017); Nyamongo & Temesgen (2013); Tai (2015) and Manini & Abdillahi (2015) discounted the notion above, opining that corporate governance variables were negatively related to firm performance. It is however, crucial to note that these studies were carried out in developed and stable economic environments results which may be peripheral to their developing and unstable counterparts. Corporate governance may therefore be indignity to the country specific obtaining institutional factors. The current study therefore focuses in line with Mangena et al. (2012; Wadesango & Makerevi (2018) on the possible effects of a turbulent economic and political environment on the relationship between corporate governance and financial performance of commercial banks.

LITERATURE REVIEW

As outlined in the methodology section above, the study adopted a desktop research methodology. It interrogated and critiqued documents on what other researchers in their different contexts had established in view of the effects of corporate governance on financial performance of commercial banks in a turbulent economic environment. The literature interrogated was as follows: relationship between corporate governance and firm performance in a stable political and economic environment, audit committee and firm performance, board composition and firm performance, benefits of practicing good corporate governance, relationship between corporate governance and firm performance in an unstable economic environment and relationship between corporate governance and firm performance in an unstable political environment.

METHODOLOGY

This theoretical paper adopted a desktop approach methodology. Desktop methodology is different from empirical study in that data is collected from relevant documents. The article interrogated literature so as to ascertain the effects of corporate governance on financial performance of commercial banks in a turbulent economic environment. The researchers used secondary sources of data such as internet journals, e-books and books from the library in their research.

RESULTS AND DISCUSSION

Relationship between Corporate Governance and Firm Performance in a Stable Political and Economic Environment

Board size and firm performance

Board size denotes the total number of directors in a board who are in possession of voting rights. Earlier studies in the banking sector have produced mixed results pertaining to the relationship between board size and performance (Adams & Mehran, 2012; Aebi et al., 2012; Wadesango & Mwandambira, 2018).

A study by Sheik & Wang (2012) revealed that a positive relationship existed between board size and firm performance in a stable business operating environment and further stated that the market responds positively to an increase in board size. The study reported that large boards are beneficial as they provide firms with poor operating performance as a result of diverse backgrounds and communication skills with better monitoring. The study suggested that an array of applicable and complimentary experience, skills and knowledge necessary to direct the organization towards a desired direction and an improvement in strategic decision making of a business is obtained by the adoption of a large board.

Studies by Lekgotho (2018) supported the notion of having a large board of directors. They revealed that a large board if adopted would contribute positively to the company by harnessing knowledge, opinions and quality proposals that would culminate in beneficial investments for stakeholders. These study findings were also confirmed by those of Masaka (2012 who averred that corporate reputation tends to be demonstrated in companies with large boards as compared to the ones with boards that are smaller in size.

However, the results are contrary to Zabri et al. (2015) who in their study obtained a negative relationship between size of the board and the firm's performance. They submitted that coordination problems arise as a result of big boards and numerous other challenges culminate from the employment of such a board. That is in support of the view in the organizational behavior theory that large work groups lead to a decline in the productivity of workers. An empirical study by Maune (2017) established that size of the board was negatively related to performance as measured by return on assets (henceforth ROA). Such empirical results are in line with findings Mwandiambira (2017) who submitted a negative impact on profitability was evident in listed firms with large board of directors. This relationship was also found in Asian economies like Japan Malaysia (Shukeri et al., 2012) and Pakistan (Yasser et al., 2017) as well as in emerging economies in Africa like the case for banks in Kenya.

Audit committee and firm performance

A study by Ojeka et al. (2014) investigated the effect of a firm's performance on a sample of 25 manufacturing firms operating in Nigeria for the period 2004 to 2011. Variables which included size, independence of the audit committee amongst others were used for the investigation. It was concluded through the study, that the audit committee is related positively to performance with ROE as a measure of performance, using Pearson Moment Correlation. Adoption of independent audit committees was recommended by the research for the enhancement of shareholders' value in firms as there is reliability in investing in such firms. Investors tend to have more confidence with companies that align themselves to best practices of good corporate governance principles that recommend an audit committee that consist of independent directors. The integrity of the financial statements is rarely doubted in such scenario. Ojeka et al. (2014)'s results were valid in the context of Malaysia where the study was carried out. The operating environment of Zimbabwe and Malaysia are different.

Board composition and firm performance

According to Bijalwan & Madan (2013), board composition refers to the board size, classification ratio into executive directors (EDs) and non-executive directors (NEDs) and independence of the board. Previous empirical studies found some mixed results on the relationship between board composition (NEDs) and firm performance (Mangena et al., 2012).

A study on relationship between corporate governance and firm performance was conducted in Ghana (Wadesango et al., 2017). The research investigated the effects of corporate governance on financial performance of Ghanaian universal banking companies during the period 2006-2014. Multiple regression panel data analysis was used to conduct the study. The findings showed that board size, board composition, bank size and foreign ownership are positively but insignificantly related to profitability in terms of return on asset and return on equity in the banking sector of Ghana. The findings of the empirical investigation show that the association the association between bank performance and different corporate governance mechanisms is complex and dynamic optimal governance arrangements may differ from bank to bank in relation to governance characteristics.

Benefits of Practicing Good Corporate Governance

Competitive advantage

The performance of a firm can be maximized by applying correctly good corporate governance principles which in turn gives competitive advantage to a firm. Corporate governance has been and will always be crucial in earning confidence and trust from investors. Good corporate governance practices do not however guarantee superior performance of firms, in as much as effective and efficient boards cannot guarantee companies will be hit by crisis. A study by Mwandiambira (2017) supported the notion that sound corporate governance principles create a competitive advantage to a bank thereby positively influencing bank financial performance.

Increased foreign direct investment

According to a study undertaken at the Stanford Law School, institutions scouting for investment opportunities are more likely to invest in companies that employ good corporate governance principles. An empirical study by Claessens & Yurtoglu (2013) concluded that through the adoption of good corporate governance, firms earn the potential to attract capital investment which in turn benefits the economy through foreign investments. Similar results were obtained in China, where a study was carried out on 154 Chinese firms to determine the drivers of foreign investments (Cui et al., 2014). The study concluded that foreign direct investment was dependent on firms' governance structures. The research of Claessens & Yurtoglu (2013) and Cui et al. (2014) both reasoned that investors have confidence injecting their resources into firms that embrace good corporate governance practices. The firms have stability and aim to enhance investors' value. Apart from being stable, firms which employ corporate governance principles were also said to be able to safeguard resources entrusted to them (Wadesango & Mhaka, 2017).

Relationship between Corporate Governance and Firm Performance in an Unstable Economic Environment

Board Size and firm performance

An empirical study on corporate boards, ownership structure and performance of firms in an environment of economic and political crisis was carried out by (Mangena et al., 2012) in Zimbabwe. The study made use of panel data for companies listed on the Zimbabwe Stock Exchange (ZSE) covering the period 2000 to 2005. The study was divided into two different phases, one being regarded as having been stable and the other unstable economically and politically. This was done to capture the difference in the political landscape. The Generalized Method of Moments (GMM) was used for the analysis of data collected. According to the empirical study, in the stable period, performance of firms was found to be related to the size of the board in a positive direction. The researcher also submitted that during the two different environments, board independence relation to firm performance was negative. The study results supported the notion that a firm's operating environment determines the effect of the board structures in terms of ownership and are therefore crucial for policymakers. According to the study performance was negatively related to executive director's share of ownership in the post presidential period. Proportion of NEDs was negative and significant in the two periods. These results supported the notion that the effects of board and ownership structures depend on the nature of a firm's environment and has therefore crucial implications to policymakers.

Board composition and firm performance

A study on board characteristics and firm performances in emerging economies was carried out in Romania in 2017. The study investigated correlations between six boards of directors' characteristics. These included competence training, equilibrium between NEDs and EDs, board independence amongst others. 55 firms listed on the Bucharest Stock Exchange (BSE) in 2012 were used for the study with measures of performance being ROA and Tobin's Q. The study concluded that there was no significant association between all the six board characteristics and performance. The findings concurred with those from numerous studies conducted in developing countries and were explained by various shortcomings which characterized the lagging of transition economies.

Khan & Awan (2012)'s study found out that independent board members have no interest relationship with the company so they have little or no conflict of interest which helps to ensure board members of the company do not influence decisions based on their interests. Wang (2014) supported the findings of Khan & Awan (2012) when the author concluded that independent directors reduce the risk of collusion between management and internal board members. Independent directors are appointed to the board to formulate strategies and maximize value for the shareholders (Wadesango & Wadesango, 2016).

Audit committee and firm performance

Chikudza (2013) conducted a study to examine the effects of corporate governance on commercial banks was carried out by focusing exclusively on Agribank. The study found out that there is a positive relationship between audit committee and firm performance. The study revealed that at Agribank there was an audit committee composed of independent directors whose responsibility was to appoint external auditor, overseeing work of internal auditors and ensure the audit findings were properly executed. That was in line with the combined code of corporate governance as well as the King three code of corporate governance. The study indicated that firms tend to violate financial regulations in a volatile economy and the audit committee to check such violations in order to minimize business risk on the organization. The study recommended that there must be an overhaul of the enforcement machinery and composition of audit committees, whose members should be more observant to their responsibilities.

The results of Chikudza (2013) are in conformity with those of Mohamed et al. (2013) who found out those board committees which include Audit, Remuneration/Compensation, and Nomination Committees also have a significant and positive impact on profit margin. The study was conducted in Egypt whilst focusing on Egyptian listed companies using the random effects model.

Benefits of Practicing Good Corporate Governance

Improved ability to deal with change

The business environment is dynamic. The turbulent and volatile economic and business environment calls for innovative and creative leaders who quickly adapt to the changing business environment. A firm which embraces good corporate governance systems is better able to deal with change. Banks require good corporate governance to enhance shareholder value and therefore should be able to quickly adapt where the environment changes (Wadesango et al., 2018).

Relationship between Corporate Governance and Firm Performance in an Unstable Political Environment

Board size and firm performance

Mwaura (2017) carried out an empirical study on relationship between board characteristics and profitability of commercial banks in Kenya. The study was a census survey covering all the 43 commercial banks in existence in Kenya. The study was carried out using secondary data of audited annual reports for the period 2012-2016 of the 43 commercial banks of Kenya. The study found out that there is a significant positive relationship between the factors that include board expertise, board size, director independence, board diversity and financial performance of commercial banks: and it indicated that they influenced profitability of commercial banks. The study then recommended on the need to improve key board characteristics like board size and expertise in order to significantly improve profitability of commercial banks.

However, it is critical to note that the political environment of Kenya and Zimbabwe is different. Therefore, the results showing a significant positive relationship between board size and bank performance may not perfectly apply to the Zimbabwean case. It is also important to note that political disputes characterized the Kenyan environment which also affected their banks. For instance, in 2017 the ruling party won election results which were disputed by the rival presidential candidate Raila Odinga and the results were successfully challenged at the highest court in the land of Kenya. Such an occurrence has never happened in the history of Zimbabwe.

Audit committee and firm performance

Amer (2016) undertook an empirical study in Egypt to investigate the effect of characteristics of an audit committee. Companies listed on the Egyptian stock exchange were used for the study and ROE, Tobin's Q and ROA were used as performance measures. The results of the study showed that audit committee size was negatively related to the performance of firms. Adigwe et al. (2016) also found a positive relationship between an audit committee and performance of a Bank.

Board composition and firm performance

A study on board characteristics and firm performance was carried out in Egypt by Amer (2016). The research approach adopted in the research covered GLS random effect regression over the nine-year period covering 2004 to 2012 in respect of 50 most active listed companies at the Egyptian stock exchange. The study revealed that that there is a positive relationship between the proportion of independent directors on the board and firm financial performance as measured by Return On Equity (ROE), CEO duality also showed a significant positive relationship with ROE, and the director ownership was also found to be positively associated with firm performance as measured by ROE, but the relation was not significant.

However, it is important to note that part for the period covered by the study was characterized by political turmoil that erupted in Egypt. In 2011, when hundreds of thousands of Egyptians took to the streets in an ideologically and socially diverse mass protest movement that ultimately forced longtime president Hosni Mubarak from office. A protracted political crisis ensued, and the Supreme Council of the Armed Forces took over control of the country until a series of popular elections brought the Muslim Brotherhood finally took power which was later lost to Abdel in 2013. Given the political instability that was prevailing in Egypt, the results may not reflect the relationship between board composition and firm performance in the context of Zimbabwe. Whilst, the November 2017 political change of power in Zimbabwe can be likened to the political 2011 political unrests of Egypt, the handover of power in Zimbabwe was bloodless and non-violent. Therefore, the influence of the political environment on the relationship between board composition and firm performance in Zimbabwe and Egypt is different. Such a gap is covered by this research.

Summary of Findings

This theoretical paper found that there is a significant connection between board size, proportion of non-executive directors, size audit committee and leverage, with financial performance of commercial banks measured by return on equity. This can be attributed to the fact that the bank's business relies heavily on trust that clients have in the management of the bank and the more transparent they are, the more the disclosures the more trust they earn from their clients and the better a bank's management manages the risk, translates into growth and better financial performance. It was also found out that political risk has more negative impact during on bank performance and it requires a more proactive board to manage the bank during times of political upheavals.

CONCLUSION

Corporate governance improves a firm's corporate competitiveness and positively impacts its profitability level when the political risk is very low as noted during the period 2009-2013. However, the results were different during times of high political risk, when corporate governance must change from being reactive to being proactive, managing political risk and political relations, absorbing political shocks. The study reveals that during times of high political volatility, the board of directors could try to make profit maximization the main goal in order to drive the bank towards making profits as the chances of making losses will be very high. This comes from the fact that the board is expected to manage all the bank's forms of risks, through both the risk management committee and the audit committee. It is evident that corporate governance performs a major function in the overall growth and success of banks. The results from the investigation indicate that the rights of shareholders, transparency and disclosure and board operation enhance performance and eventually improve shareholders' value. The results of the research give a strong support to the idea that good governance framework is crucial in the financial sector as it positively influences firm performance. The findings of this study advocate and support good corporate governance practices in commercial banks as a tool of curbing bank collapsing. This yields an overall effect of promoting economic growth and development of a country since the financial sector plays a key role in the nation's GDP.

RECOMMENDATIONS

The study recommends: 1) good governance framework in the financial sector as it positively influences firm performance 2. Good corporate governance practices in commercial banks as a tool of curbing bank collapsing.

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