CORPORATE GOVERNANCE AND BANKS FINANCIAL PERFORMANCE: A SURVEY OF LITERATURES

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ABSTRACT

This study provides a review of literatures on the relationship of corporate governance and banks financial performance. Corporate governance is associated with the process of governing and observation of the departure of managers from actual control of banking corporations by the Board as conflict of personal interests among managers are particularly to be great. Subsequently, this study defines corporate governance in the context of banking as the manner in which the systems, procedures, processes and practices of banks are properly managed so as to allow positive exercise of managers' responsibility by meant of accountability and transparent administration, with the aim of attaining banks impressive financial performance. In the governance-banks financial performance literatures, a large body of research has empirically shown that sound corporate governance exerts positive impact on banks financial performance. Sound corporate governance suggest that well-functioning of accountable and transparent banks managers are significant in running the banks operational activities not in their own interests, rather than those of shareholders and for benefit of the banks. From the classical views, sound corporate governance of banks has been recognized as a significant catalyst that contributes positively to banks performance. Sound corporate governance has been shown to enhance banks performance by lowering agency cost; managers' misconduct or mismanagement behavioural, abuse of power or authority and exploitation of control, and ensuring that resources and capital flows are steered towards the most productive use possible. The paper provides a platform for future research.

Keyword: *Corporate governance, banks financial performance*

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1. Introduction

Consequential of Industrial Revolution in the eighteen century, there was an increased development in economic activities which lead to the tremendous establishment of companies. According to Williamson (1975), as the owners of these companies are not favorably fit in charge for the companies, they hired professional management to manage the companies on their behalf. This situation created the stewardship or agency concept[1] being implemented in managing the companies (Berle and Means, 1932)[2]. Smith (1838) as cited in Cadbury Report (2002), drew the attention of the important of governance on corporations by saying that, the directors of such companies being the managers of other people money than of their own, it cannot well expected that they should watch over it with the same anxious vigilance with the partners in a private partnership frequently watch over their own. Negligence and profusion therefore must always prevail, more or less, in the management of the affairs of such a company.

Soon as there was separation between the ownership and the managements of the companies, in order to prevent agency cost that arises under the agency concept and to protect the shareholders' interest, there commenced the need for mechanism of controlling the agency costs and also an effective system to govern the corporations efficiently (Blair, 1995). Jensen and Meckling (1976) asserted that, agency costs comprised of three different components: monitoring costs, bonding costs and residual loss. Monitoring costs are the control costs incurred by the principal to keep the devious behavior of the manager in check. Bonding costs are those costs incurred to ensure that managers take decisions conductively to the shareholders' interests. Residual loss occurs when both the above kind of costs fail to control the divergent behavior of the manager (Jensen and Meckling, 1976).

Hence, Tricker (1984) pointed out that, corporate governance is concerned with supervising and monitoring management performance and accountability. In such circumstances, Cadbury Report (2002) revealed that, corporate governance is associates with a system by which companies are directed and controlled and the process by which corporations are accountably responsive to accomplish the rights of its' stakeholders as a whole. In addition, Cadbury (2002) further explained that, both the system and process are delineated the Board of company to work within boundaries which constructed by laws and regulations, constitutions of the companies and resolutions attained in the annual general meeting. More precisely, Higgs (2003) revealed that, the system is related to the management methodology and operational procedures of a corporation; emphasizing with the control structures and the allocation of responsibilities within companies, which are systematically organized.

[1] A contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent (Jensen and Meckling, 1976).

[2] Cited in Cadbury Report (2002).

2. The Need of Corporate Governance on Banking Institutions

Grant (2003) did mentioned that, corporate governance is a mechanism which concerned with the alignment of management structures within the Board and the allocation of responsibilities among directors and senior management of companies in maintaining appropriate arrangements and controls. More specifically, corporate governance has concentrated on the relations between the directors and managers of the corporation and its shareholders (Dewing and Russell, 2004) and stakeholders other than the shareholders interest (Schachler et al., 2005). In such a way, according to Schachler et al., (2005), the corporate governance framework should purportedly motivate those in control to increase the corporate wealth. It was because as Schachler et al., (2005) noted that, sound corporate governance practices should motivate and promote the managerial behaviour toward improving the corporate business performance turn to be more effective and efficient, as corporate governance directly controls the behaviour of the managers.

OECD (1999) has earlier admitted for a wider network of corporate governance in an organization for maintaining the emphasis on the relationship among its stakeholder groups as a set of relationships between a company's management, Board, shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the Board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently (Shleifer and Vishny, 1997). Hence, fundamentally, the governance framework is acting as guidance that lead the corporation's management managerial behavior or trend headed toward achieving successfully the corporation goals and business objectives, and at the same times shall fairly entertain all of the stakeholders' interest.

Misconduct or mismanagement of banking business activities due to weak corporate governance are not a new phenomenon[3]. Despite that financial markets are well-developed and relatively sophisticated, there have been sufficient system weaknesses to enable episodes of financial company collapse or malfeasance (Schachler, 2007). The consequences of the destructive impacts of weak corporate governance in financial institutions were not only strike on economical financial losses, but also caused a serious deficit in social and human life. It includes the destruction of investors' confidence, raised doubts about the stability of the financial system and destroyed the value of all other stakeholders and the communities at large (Grais and Pellegrini, 2006). Tricker (1984 Rechner, 1989 Williamson (1996 Bingham, 1992

According to Tricker (1984), corporate governance is needed to ensure that businesses are running properly for the realization of the organizational goals such as to maximize company wealth. Therefore, corporate governance should include of

[3] For example, see the case of Barings' failure due to unauthorized derivatives transactions as the consequences of weak internal and external control (Kornert, 2003). For examples; the collapses of BCCI, England (one of the world's largest banks) in 1991 as its involvement in a number of fraudulent activities (Bingham, 1992). The failure of Baring Bank in 1995 as it engages with unauthorized derivatives on East Asian exchanges (Kornert, 2003).

Board and management behaving in ethical ways and in compliances with laws and regulations where the concept of accountability, transparency and trustworthiness is set in (Rechner, 1989). According to Williamson (1996), normally corporate governance would ensure that the managers' fiduciary duties in ascertaining the corporation's objectives are with regard to the interest of the organization.

In the banking sector for instances are the collapse of Bank of Credit and Commerce International (BCCI), England (one of the world's largest banks) in 1991 (Bingham, 1992) and the Barings Group failed with estimated losses of £927millions in 1995 (La Porta et. al., 1999). Hogan (1997) claims that the collapse of BCCI and Barings had little to do with the use of derivative financial instruments but more to do with the critical control gaps; the failure of management in its monitoring and analysis of trading activities and the risks associated with them, the failure of internal corporate governance structures of Barings Group. Heracleous (2001) substantiated it by verifying that the control mechanisms in Barings Group was typically lagged behind. Thus, Heracleous (2001) proposed that, the corporate governance structures of Barings Group to emphasize more on the significant need for management to develop a sound control system for the business operations activities.

The end goal of corporate governance is then to maximize the economic efficiency of the firm. Thus, the needs of sound corporate governance are essentially necessitating as its function specifically as corporate monitor and to control managerial shirking through greater transparency and accountability (Schachler et al., 2007). In such a case, corporate governance is significantly needed as mentioned by Schachler et al., (2007) as in the absence of the protections that good governance supplies, asymmetries of information and difficulties of monitoring mean that capital providers who lack of control over the corporation will find it risky and costly to protect themselves from the opportunistic behavior of managers and controlling shareholders. According to Surgeon (2003), normally responsibility and accountability of a corporation are heaped on the director's shoulder. Thus, directors are responsible not only to increase the value of share by enhancing the company performance, but in the same time are accountable with the decision that they have made.

Grais and Pellegrini (2006) emphasized that, principally, the needs of corporate governance for institutions offering financial services is significant for their economic development since the assets of banks are huge and from time to time keep on growing tremendously. Consequently, a systematic and procedural ways of governance is needed to ensure the sustainability and survival of the banks' business that are in the fast moving economy with highly competitive market forces and to attain the highest level of integrity and trustworthiness in the financial market that creates a long lasting relationship between banks and its stakeholders.

Good corporate governance is more than a good idea. Because it encourages flow of investments, lowers the cost of capital and supports strong financial markets (William, 2003). As such, corporate governance is essential for the development of a vibrant and sound banking industry. According to William (2003), corporate governance represents structures and processes that entail individuals carrying out business whilst exercising professional discretion in a way that exhibits integrity, honesty and fairness. Hence, Ahmad (2002) clarified that, sound governance principles are essential for banks as a systematic and procedural ways to ensure the sustainability and survival of the banks' business that are in the fast moving economy with highly competitive market forces.

In addition, the need for sound of governance practices for banks is significantly essential for reducing financial crime, securing an appropriate degree of users' protection and maintaining market confidence in the financial industry sphere. According to Abdul Rahman (1998), sound corporate governance, especially in Islamic banks is significantly relevant as it will improves the Islamic banks' operational performance, enhances systemic financial stability, and contributes protection for the rights of shareholders as well as of other stakeholders welfare. It is because corporate governance is basically associated with the moral and ethical dimensions of managing a company's business.

Thus, corporate governance of banks will drive everyone in the institutions to be more objective and committed of managing in accountability, managing in transparency and managing in trustworthy in the most highly ethical way that will exhibit effectiveness and efficiency. Thus, a good governance system is essential for banks as it should comprise the structure of a system in operations, controlling, and monitoring an Islamic bank of achieving its long term goals, building shareholders' value by establishing a dominant market share and become a leader in its sphere. The governance is pursued by maintaining excellent relationship between the Islamic bank and its stakeholders in term of quality and Shari'ah compliant services or products provided. And finally, maintaining compliance with all legal and regulatory requirements under which the Islamic banks in operation.

Hence, it was learn that corporate governance has mainly aimed to enhance transparency, accountability, integrity, honesty and fairness and trustworthiness of the bank corporation's management; the Board, managers and staffs, toward profit maximization. Subsequently, the concept of corporate governance was proposed as a result of increasing awareness about the importance needs to protect the banking corporation from the managers' personal interest. Subsequently, good corporate governance of banks comprise of a comprehensive governance policy framework that set out the strategic roles and functions of each governance organ and the mechanisms for balancing the banks' accountabilities to the stakeholders. But, it is in fact, corporate governance is a systematic framework that provides a blueprint for the strategic roles and functions of the banks' Board, Board committees, management, to manage themselves in the best interest of the stakeholders.

3. Corporate Governance and Banks Financial Performance

According to Pi and Timme (1993), among the main factors that support the excellent performance, besides the banks effective marketing discipline, strong prudential regulation and supervision, accurate and reliable accounting financial reporting systems, sound disclosure regimes and an appropriate savings deposit protection system, is sound corporate governance. Corporate governance comprises of corporate governance elements and corporate governance mechanisms. Corporate governance elements are comprises of procedures, processes, systems, codes of conducts, ethics and, rules and regulations that lay down in a bank. Whilst corporate governance mechanisms are consist of Board and Audit Committee in a bank.

OECD (1999) reveals that, governance mechanism is about the way in which Board oversees the running of a company by its managers, and how managers are in turn accountable toward achieving corporate excellent financial performance. It is

because, the existence of sound governance mechanism will discipline managers by having the appropriate levels of accountability and checks and balances within a bank (OECD, 1999). It is upon this system that specifications are given by the Board for division of competencies and responsibilities to managers in implementing the formulated rules and procedures on corporate matters that develops corporate competitive advantage of banks (OECD, 1999).

In such circumstances, Cadbury Report (2002) also revealed that, governance mechanism is associates with Board monitoring system by which managers are directed and controlled, and the process where managers are accountably responsive to accomplish the firm's corporate objectives as a whole in attaining better financial performance. Cadbury Report (2002) further explained that, the governance mechanism of managers monitoring system, delineated the Board to ensure managers work within boundaries which constructed by laws and regulations, constitutions and resolutions of the companies. More precisely, Higgs (2003) revealed that, Board as the monitoring and supervising mechanisms of governance is related to monitoring the managers methodology and operational procedures of a corporation, emphasizing with the control structures and the allocation of responsibilities within companies, which are systematically organized.

Board is a group of people carrying equal responsibilities of leading and directing company with primary objective in making strategic decisions on long-term thrust and direction of any organization, that affect the long term financial performance of the organization (Walt and Ingley, 2001). Walt and Ingley (2001) expose that, creating a vision, mission and values; developing corporate culture and climate, positioning in the dynamic market, setting corporate direction, reviewing and deciding key corporate resources, deciding implementation mode and processes of governance are all part of the strategic decisions that the Board uses in directing the thrust of any corporate entity's toward achieving excellent financial performance. Board plays a crucial role of oversight the governance implementation by managers (William, 2003).

On the other hand, Audit Committee is empowered to function on behalf of the Board, an important oversight; control and monitoring roles of the governance structure intended to ensure efficiency of the corporate accountability (Marvin, 1989). Audit Committee primary task is to oversight the integrity of the financial reporting controls and procedures implemented by managers of banks. For that reason, Audit Committee is mandates mainly to review and monitor the entire accounting and non-accounting process of banks (Pomeranz, 1992). To do so, Audit Committee shall regularly check with each organ of governance units for the compliance function of the banks' financial and non-financial reporting process (Pomeranz, 1997). As such, according to Turley and Zaman (2004), Audit Committee provides input and recommendations to the Board with regard to any operational or financial matters. Being one of the key determinants of sound governance mechanism, Audit Committee therefore could significantly bring banks to a higher level of financial performance and competitiveness (Turley and Zaman, 2004).

Turley and Zaman, (2004) explains further that, sound corporate governance facilitates the works of banking supervision by sound co-operation between both Board monitoring and Audit Committee oversee managers of a bank in facing the impact of an increasingly open banking competition environment; rapid changes of banking system, innovative products and services development, and technological

advances. Hence, Board and Audit Committee are corporate governance mechanisms that responsible of setting corporate objectives, monitoring the day-to-day operations of the business, align corporate activities and behaviours with the expectation that banks will operate in safe and sound manner, and in compliance with applicable laws and regulations and protect the interests of depositors (Berger et. al., 2005). Indeed, those proper, appropriate, transparent and accountable management elements of sound governance are directing banking institutions toward a competitive institution among domestic banks (Berger et. al., 2005).

Hence, sound governance practice is a significant instrument to banks excellent financial performance. It is because sound governance practices means little expropriation of corporate resources by managers, which contributes to better allocation of resources; a more efficient banking operational business activities and yield better corporate financial performance (Carcello and Neal, 2000). Furthermore, banks with sound governance practices will incur lower costs of capital. Lower cost of capital is a competitive advantage of domestic banks in facing the impact of an increasingly open banking competition environment (Clark and Rama, 2008). Sound governance practices is also focus on prevention of fraud, risk management and legal non-compliance and prevent the maximization of managers' personal interests; minimizing the agency cost (Carcello and Neal, 2000). As such, it could reduce the probability of financial statement manipulation and more incentive to deter earnings management (McMullen and Raghunandan, 1996). Consequently, sound governance practices will decrease the agency cost risk and increase profit maximization; excellent financial performance that increase the bank value (Clark and Rama, 2008).

Sound corporate governance of banks comprise of a comprehensive governance policy framework that set out the strategic roles and functions of each its operational organ by managers and the mechanism for balancing the managers' accountabilities. In fact, governance mechanisms is a systematic element in the corporate governance framework that provides a strategic roles and functions of the banks' Board and Audit Committee in ensuring bank managers execute their responsibilities in the best interest of the bank (Judge and Zeithaml, 1992). Subsequently, the qualitative characteristics of Board and Audit Committee are important in determining the effectiveness of the managers' team behaviour whose preference is to choose alternative or decision that would maximize their personal rather than company's interests (Jensen and Meckling, 1976). Thus, instilling sound governance practices is crucial element for Board and Audit Committee of domestic banks for achieving sound financial performance in encountering the impact of an increasingly open banking competition environment.

Furthermore, according to (Spong and Sullivan, 2007), sound governance mechanism in banking institutions empirically implies Board and Audit Committee supervision for quality managers on six performance areas; capital adequacy, assets quality, management, earnings, liquidity, and sensitivity risk. (Spong and Sullivan, 2007) further asserted that, the degree of achievement to those six parameters determine the quality operations that give positive impact to sound financial performance of a bank. Thus, performance of a firm, as identified by (Spong and Sullivan, 2007) depends on the effectiveness of Board and Audit Committee acting as the governance monitoring and supervising mechanisms. Thus, Board and Audit Committee is essentially necessitating as its function as a governance monitor in

controlling managerial shirking, is actually more specifically to maximize firm value and financial performance through greater transparency and accountability (Macey and O'hara, 2003; Schachler et al., 2007).

Likewise, in facing the impact of domestic banks rapid changes of banking system, innovative products and services development, and technological advances competitive toward attaining excellent financial performance, Board and Audit Committee are to ensure managers of banks to be more discipline, transparent and accountable in performing their job for minimizing agency risk, and provides efficient services for the purpose of banking business activities without wastage of resources (Van der Walt and Ingley, 2004). Board and Audit Committee is therefore critical for constructing banks to be more competent in facing the impact of the competition toward attaining excellent financial performance. Thus, the sound financial performance of a bank is depending on the underlying soundness of its individual governance mechanism and the robust connections between them, where the end goal of corporate governance is to maximize the economic efficiency; financial performance of the banks.

Whereas governance mechanism is referring to the Board effective controlling and monitoring managers concerning the bank business operation activities (Davidson et al., 2005). Governance mechanisms of banks refer to the processes, structures and information used for directing and overseeing managers and its affairs in order to improve the banking organizational performance and long term firm value by enhancing corporate accountability. Furthermore, besides maintaining compliance with all legal and regulatory requirements under which the bank operates, Board is also responsible for fulfilling long-term strategic goals by establishing a dominant market share and being a leader in the banking sphere (Staikouras et al., 2007).

Corporate governance of banks is about Board and Audit Committee building credibility, ensuring transparency and accountability, maintaining an effective channel of information disclosure as well as to be competent to other banks (Tanna et. al., 2008). Thus, governance mechanism is through which managers are supervised that they will not act in their interests in increasing the bank's financial performance and eventually rise up the bank value. As such, Board monitoring on managers' practices of sound governance, plays a vital role in underpinning the integrity and efficiency of managers in attaining bank excellent financial performance (De Zoort, 1997).

Besides that, corporate governance provides the structure through which the objectives of wealth maximization and sound financial performance of a banking organization are set, and the means of attaining those objectives are determined (Tricker, 1984). The Board fiduciary duties of monitoring managers' activities where the concept of accountability, transparency and trustworthiness is set in, play an important role in improving sound governance practices in a banking business organization (Zulkafli and Samad, 2007). As such, (Zulkafli and Samad, 2007) reveals that, the Board is said as acting as a governance mechanism in monitoring managers to pursue their efforts for effective governance practices in realizing the objectives and goals of a banking organization excellent financial performance.

In addition, Higgs (2003) and Grant (2003) mention that, governance mechanism is concerned with the Board alignment and monitoring of management structures and the execution of responsibilities among managers of banks in maintaining appropriate arrangements and controls (Dewing and Russell, 2004). In

such a way, according to Schachler et. al., (2007), Board and Audit Committee is purportedly inspiring to motivate those managers in control to perform sound managerial behaviour for increasing the banks corporate wealth; sound financial performance.

The effectiveness of a bank's governance practices has a substantial relationship on the ability of the Board to monitor and control, besides the Audit Committee oversee risks of agency cost and mismanagement within the bank. With the help of Board and Audit Committee arrangements on regulations, business corporate values, codes of conduct and other standards of appropriate behaviour, and the system used to ensure compliance with them, corporate governance on banking institutions has been seen as an economic discipline that assist to achieve an increase in the banking institutions financial performance (Godfred, 2013). Thus, sound governance practices will therefore strengthen the banking institutions if their positive financial performance is to be achieved and to evade banking corporate failures consequently affected by aggressive open banking competition environment. As such, in an increasingly open banking competition environment, there is therefore the need for banking institutions to have both resilient code of corporate governance and sound corporate governance practices.

4. Conclusion

The changes of improvement to governance elements and governance mechanism could cause managers to better align their interests with that of the banks, hence increases firm financial performance, and thus resulting in the higher firm value. Hence, sound governance mechanism therefore are essentially vital for ensuring the governance elements that laid down procedures, processes, systems, codes of conducts, ethics and, rules and regulations are implemented accordingly in a bank. Accordingly, governance mechanism of banks is an internal supervision arrangement mechanism on supervising and monitoring banks managers that can positively give impact on the financial performance of banks.

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