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Are board attributes and ownership structure value relevant in developing economies: new institutionalist perspective

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Abstract

Purpose – The author aims to find value relevance of board characteristics and ownership structures in the banking industry of Bangladesh, an emerging economy with absence of good governance.

Design/methodology/approach – Pooled Ordinary Least Square (OLS), fixed effect and generalized method of moments (GMM) methods have been utilized to analyse 5-year data of 28 listed banks.

Findings – All governance indicators except institutional ownership have insignificant impact on return on asset (ROA) and return on equity (ROE). Institutional ownership has significant negative impact indicating that institutional investors can worsen bank performance in unregulated environments. Additional analysis shows significant positive impact of higher institutional ownership ratios.

Research limitations/implications – Small sample from a single industry of one country may limit the applicability of the findings to all developing economies.

Practical implications – During the fast growth periods of developing economies, institutional investors with small stakes may become value destructive due to speculative behaviour.

Originality/value – This is one of the pioneering studies to suggest that governance mechanisms have insignificant, in some instances adverse, impact on firm value in emerging economies.

Keywords Bangladesh, Developing countries, Corporate governance, Board of directors, Ownership structure, New institutionalism

Paper type Research paper

1. Introduction

Trivial research on impact on corporate governance and ownership structure has been done in developing countries (Rashid *et al.*, 2007). Corporate governance mechanisms were introduced in Bangladesh due to pressure from international donor agencies (Siddiqui, 2010). However, adopting regulatory reforms without considering local socio-political contexts may not be effective. Moreover, many authors (e.g. Berglöf and Claessens, 2006) identify legal enforcement as key to successful implementation of corporate governance mechanisms in developing economies. Prospect of governance mechanism in Bangladesh therefore becomes a concern due to the weak institutional environment.

Several unique attributes make the Bangladeshi banking sector a good natural experiment field. Firstly, though Bangladesh adopted the Anglo-American model of corporate governance deemed unsuitable for emerging economies due to coercion from donor agencies (Siddiqui, 2010) to gain legitimacy, several attributes of the corporate governance context align with

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German-Japanese model (Rashid *et al.*, 2007). This inconsistency may make governance mechanisms fail. Moreover, reforms due to isomorphic pressures may be overridden by strong institutionalized practices (Scott, 2005). Secondly, among the developing countries, Bangladesh is undergoing one of the fastest economic progresses. Strong financial system incorporating banking channel bears enormous significance for an economy relying highly on foreign remittance and export revenues (The World Bank, 2022a, b). However, the banking sector is undergoing severe irregularities including rising non-performing loans, liquidity crisis and default scams involving banks' top management (Fariha *et al.*, 2022). Regulatory supervision in the banking sector became more of a concern when the central bank itself lost USD 1 billion in one of the largest cyber heists in the global banking history in February 2016 and such incident remained concealed from public for weeks. A study on effectiveness of corporate governance mechanisms in the banking sector of Bangladesh is therefore a demand of time.

Though corporate governance is a dynamic mechanism in developing economies (Bhaumik *et al.*, 2019), to the best of my knowledge, none of the papers in the Bangladeshi context utilized dynamic panel models. Moreover, the papers utilizing data from the banking sector of Bangladesh (e.g. Fariha *et al.*, 2022; Rouf and Hossain, 2018) consistently used data on all the listed commercial banks without identifying the outliers. Such papers also rarely tested robustness of their models. So, there remains a scope of methodological improvement.

I aim to find effects of board attributes and ownership structure on accounting performance of Bangladeshi listed banks. Board attributes under study are size, independence and gender diversity. Institutional ownership, director ownership and government ownership are the ownership components investigated. Return on asset (ROA) and return on equity (ROE) are used as indicator of accounting performance. Data about 28 listed banks for the years 2016–2020 has been used after eliminating outliers. I have applied pooled ordinary least square (POLS), fixed effect (FE) and two-step system generalized method of moments (GMM) methods for analysis.

I find that, of the six independent variables, only institutional shareholding has significant impact on ROA and ROE. Institutional shareholdings have consistent significant negative impact in all the six models. According to passive monitoring theory (Lin and Fu, 2017), the negative coefficient of institutional shareholding may be due to institutional shareholders' involvement in speculative trading. However, additional analysis inconsistently shows that institutional shareholding may improve accounting performance if they have significant stake. Insignificance of board attributes, director ownership and state ownership indicate that governance mechanisms do not work to generate firm value in weak institutional setting. The main models are found robust after several diagnostic tests.

This study makes several contributions. Firstly, the findings clearly identify the speculative rather than monitoring role of the institutional investors with small stakes in banks. This finding, based on more robust econometric method, adds to the results of Farooque *et al.* (2007). Secondly, this research becomes one of the pioneers to apply dynamic panel estimation technique in finding value relevance of corporate governance in Bangladeshi context. Thirdly, in line with the notion of new institutionalism (Scott, 2005), this study points out that adoption of corporate governance mechanisms without considering the local socio-political context may fail to generate firm value.

Rest of this paper is arranged as follows: Section 2 presents a review of literature and develops hypotheses; Section 3 discusses the data and methods; Section 4 discusses the findings. Section 5 concludes the paper.

2. Literature review and hypothesis development

2.1 Board size and bank performance

Agency theory supports that the function of board of directors to monitor the organization on behalf of shareholders may reduce the agency costs. The benefit of bigger board size is the

larger combined knowledge that the board occupies. Someone therefore may expect bigger boards to improve performance. On the contrary, it may be argued that large boards may face coordination problems. Rouf and Hossain (2018) found larger boards to improve firm performance of banks in Bangladesh while Muttakin and Ullah (2012) found similar impact in case of Bangladeshi commercial banks. Fariha *et al.* (2022) reported impact of board size on bank performance in Bangladesh to depend on measure of performance while Rashid (2009) reported insignificant impact using ROA and ROE as measures of performance.

Several prior studies indicate that many board members of Bangladeshi banks are rather involved in value destructive activities. For example, some board members were found guilty by the central bank of Bangladesh in an investigation of a Bangladeshi Taka (BDT) 30,700 million loan default case whereas those members influenced issuance of the loan under political considerations (Fariha *et al.*, 2022). This paper therefore hypothesizes:

H1. Board size has a negative impact on accounting performance.

2.2 Board independence and bank performance

Independent directors are introduced in boards to ensure rational firm activities to increase value of firms. However, prior studies indicate that different personal characteristics (Reguera-Alvarado and Bravo, 2017), knowledge of firm and industry (Ringe, 2013), political connections (Shi *et al.*, 2018) etc. of independent directors moderate how they may affect firm performance. The impact of board independence in Bangladesh, however, remains ambiguous. Muttakin and Ullah (2012) and Rouf and Hossain (2018) reported significant positive impact of board independence on bank performance while Fariha *et al.* (2022) recently found negative impact of board independence on ROA and Tobin's Q of Bangladeshi banks. Rashid (2009) found insignificant impact of board independence.

Several early studies claim that contextual factors like family ownership (Hasan *et al.*, 2014), close tie with internal board members and inadequate qualification (Rashid, 2009) adversely affects the effectiveness of independent directors in Bangladesh. However, in June 2018, a new corporate governance guideline was introduced detailing the qualifications and provisions related to independent directors. Some recent studies (e.g. Sobhan and Bose, 2019) as a result found many of the independent directors now-a-days to have higher academic qualifications, and social acceptance. This study therefore hypothesizes:

H2. Board Independence has a positive impact on accounting performance.

2.3 Female directorship and bank performance

Presence of female directors in the board may improve firm performance through increasing investment efficiency (Shin *et al.*, 2020), improving risk assessment (Abou-El-Sood, 2021), reducing earnings management (Mnif and Cherif, 2021) etc. However, risk averse nature of females (Abou-El-Sood, 2021) may make firms forgo profitable investment opportunities. Only a few studies investigate impact of board gender diversity on firm performance in Bangladesh, but the findings are ambiguous. Fariha *et al.* (2022) found negative impact of board gender diversity on both ROA and ROE of Bangladeshi Banks while Rouf and Hossain (2018), and Muttakin and Ullah (2012) found insignificant impact.

Though female directors bring diversity in the boards, prior studies from Bangladesh (e.g. Fariha *et al.*, 2022; Muttakin and Ullah, 2012) express concern that female directors typically represent families with controlling shares. Nomination of family members to bring gender diversity can cause family duality (Fariha *et al.*, 2022) and affect performance adversely. I, therefore, hypothesize:

H3. Board gender diversity has negative impact on performance.

2.4 Institutional ownership and bank performance

Lin and Fu (2017) synthesized two opposing views of possible influence of institutional ownership on firm performance: namely active monitoring theory and passive monitoring theory. Active monitoring theory predicts that institutional shareholders of firms monitor actively the policymaking of firms. Engagement of institutional shareholders in reducing agency cost and information asymmetry can improve performance and maximize value of investee firms according to this view. By contrast, according to passive monitoring theory, institutional shareholders do not interfere the management decisions. Rather, focussing on short-run performance of firms, they trade the shares and try to gain from speculative trades. According to Pound (1988), institutional shareholders sometime may act against the interest of owners by strategically aligning with management. Among empirical studies from Bangladesh, Rouf and Hossain (2018), using bank data for the years 2012–2016 found institutional ownership having no effect on bank performance. Rashid (2009) also reported insignificance of institutional ownership for firm performance in Bangladesh. Farooque *et al.* (2007) found negative impact of institutional ownership on market to book value of equity in case of Bangladeshi listed firms. However, they also found that institutional shareholding improves firm performance if they hold significant stake in a firm. Consistent with the passive monitoring theory, Khanna and Palepu (2000) suggested that domestic institutional investors can adversely affect firm performance in developing countries. Considering the findings of Rashid *et al.* (2007) that institutional owners hold trivial shares in Bangladesh along with the suggestions of Farooque *et al.* (2007) and Khanna and Palepu (2000), this paper hypothesizes:

H4. Institutional ownership affects bank performance adversely.

2.5 Director ownership and bank performance

Jensen and Meckling (1976) projected in the agency theory that managers' work for wealth maximization of shareholders if their interests are aligned with the shareholder interests. Several studies investigate the impact of director ownership on performance in Bangladesh. Rouf and Hossain (2018) found significant positive impact of director ownership on bank performance; Rashid (2009) found significant positive impact of board ownership on ROA but an insignificant positive impact on ROE of non-financial firms. Farooque *et al.* (2007) found insignificant positive impact of director shareholding on ROA using both OLS and 2SLS. They reported reverse causality between performance and director ownership. Considering prior studies (e.g. Rashid, 2009) indicating that directors hold significant shares of listed companies in Bangladesh with an increasing trend, this study hypthesizes:

H5. Director ownership significantly improves bank performance.

2.6 Government ownership and bank performance

Extant literature on impact of state-ownership on performance of firms or banks predominantly focuses on China. Though some researchers found positive (Le and Buck, 2009) or curvilinear (Yu, 2013) impact of state ownership on firm performance, government ownership is typically viewed to have negative impact on firm performance (Aguilera *et al.*, 2021). Aguilera *et al.* (2021) found in meta-analysis based on 193 articles from 131 countries that state ownership has slight negative impact on firm performance. Sobhan and Bose (2019), in a review of literature on Bangladesh context, stated that the small body of prior literature find inconsistent impact of state ownership on corporate governance, firm performance and cost efficiency. Considering the institutionalized political-economic context, I test the following hypothesis:

H6. Government ownership affects bank performance adversely.

3. Data and methodology

3.1 Sample and data collection

The sample consists of 28 banks listed commercial in Dhaka stock exchange of Bangladesh. Though data on 30 banks are available for the period, two banks were identified and eliminated as outliers through creating residual boxplots after running initial regression. Data for 2016–2020 has been collected from the annual reports. The period bears outstanding significance in both the overall economy and the banking sector. The average rate of annual Gross Domestic Product (GDP) growth during 2016–2019 (7.2%) was far higher than the growth rate during 2010–2015 (6.19%) (The World Bank, 2022a, b), indicating an increased significance of banking channel during the period. Introduction of a new code of corporate governance in 2018 made the recent years substantial from governance perspective as well. Besides, several large banking scams including the central bank cyber heist during 2016–2020 make in an interesting period to check effectiveness of governance mechanisms. However, data for the year 2021 has been excluded due to the potential structural break emerging from the Covid-19 pandemic.

3.2 Model specification and data analysis

The following two models have been used in this paper:

$$\begin{aligned} ROA_{it}/ROE_{it} = {} & \alpha + \beta_1 INS_OWN_{it} + \beta_2 DIR_OWN_{it} + \beta_3 GOV_OWN_{it} + \beta_4 BOD_SIZE_{it} \\ & + \beta_5 BOD_IND_{it} + \beta_6 BOD_FEM_{it} + \beta_7 SIZE_{it} + \beta_8 LIQ_RISK_{it} \\ & + \beta_9 ROA_{i,t-1}/ROE_{i,t-1} + \varepsilon_{it} \end{aligned}$$

Board attributes are represented by natural logarithm of board size (BOD_SIZE), and percentages of independent director (BOD_IND), and female director (BOD_FEM) in boards. Percentage of institutional ownership (INS_OWN), director ownership (DIR_OWN) and government ownership (GOV_OWN) are the ownership structure variables. The control variables are natural logarithm of total asset (SIZE) and liquidity risk (LIQ_RISK) of banks. Liquidity risk is calculated by dividing total loan by total asset. Lagged dependent variable ($ROA_{i,t-1}$ and $ROE_{i,t-1}$) were used where necessary for eliminating autocorrelation.

Data has been analysed using Pooled OLS, FE and two-step system GMM methods. Considering the difficulty in identifying the best fitted instruments, the system GMM models were executed with internal instruments. Internal instrument set can effectively address the endogeneity issue through effective utilization of lags of independent variables (De Simone *et al.*, 2017).

4. Findings and discussion

4.1 Descriptive statistics

The descriptive statistics presented in the link (Table 1 (available online at: https://docs.google.com/document/d/1TpdVp6ojnEftvMHNBxv_KCzdz5a-81fF/edit?usp=drive_link&ouid=114554423480653247336&rtpof=true&sd=true)) shows that average ROA of listed banks is below 1% while average ROE is 11.1%. On average, there is 18.5% independent directors, and 12% female directors in the boards. Average institutional ownership, director ownership and government ownership were 21.3%, 41.4 and 0.042% respectively. The small number of female directors and very low government ownership indicate presence of tokenism. The similarity of pairs of means and medians indicate that the mean values are not quite affected by extreme values. However, average BOD_IND and average BOD_FEM are possibly affected by large extreme values as their means are significantly higher than medians.

4.2 Pairwise correlation

Table 2 (available online at: https://docs.google.com/document/d/1HOHBE9IeoX8_F1qS6x72o0EVnSNA7BPO/edit?usp=drive_link&ouid=114554423480653247336&rtpof=true&sd=true) presented in the above link shows pairwise correlation coefficients of the explanatory and explained variables. Of the independent variables, only director ownership has significant (p < 0.01) positive correlation with both ROA (0.2505) and ROE (0.2363). Government ownership has negative correlation with bank performance (−0.3069 and −0.3502) significant at 1%. Institutional ownership has statistically significant (p < 0.05) negative correlation with ROE (−0.1873) though its' negative association with ROA (−0.0595) is not statistically significant. Board size and female participation in boards have statistically insignificant negative correlation with performance while board independence has an insignificant positive association with profit measures. The strongest correlation is found between bank size and ROA, i.e., −0.5452. and no correlation coefficient is large enough to flag any problem of potential multicollinearity. Variane Inflation Factor (VIF) tests also confirm absence of any multicollinearity.

4.3 Regression results

Table 3 (available online at: https://docs.google.com/document/d/1Q-HThgRLH-BeECYZHM7hCFHKAQN7A9Q6/edit?usp=drive_link&ouid=114554423480653247336&rtpof=true&sd=true) presented in the above link shows summary of six regression models with diagnostic test results. The file in the link also discusses the fitness of the models. Models 1 and 4 represent pooled OLS results; models 2 and 5 are FE models; and models 3 and 6 are two-step GMM models. POLS and FE models with robust standard error and GMM with asymptotic standard error were used for this study.

4.3.1 Board attributes and bank performance. The results show that none of the board attributes have significant impact on either of the measures of bank performance and confirms that board attributes are irrelevant for accounting performance in the given socio-political context of Bangladesh. H1, H2 and H3 are therefore rejected. Firstly, board size consistently has insignificant negative impact on performance except that the coefficient was significant at 10% in model 6. The negative impact of board size on bank performance may be attributed to coordination and communication challenges in larger boards (Guest, 2009). Coordination within board of directors may become more crucial in special financial institutions like banks (Staikouras *et al.*, 2007). Moreover, in a family dominated corporate environment like Bangladesh (Mahbub *et al.*, 2019), board size may become larger to include more family members. Mahbub *et al.* (2019) found adverse effect of family ownership on corporate governance and bank performance in Bangladesh, and it is not impossible that larger boards are correlated with high family ownership. Secondly, consistent with Rashid (2009), persistent insignificant positive impact of board independence on bank performance has been found. The coefficient is found insignificant and negative only in model 2, the FE model explaining ROA. The insignificance of board independence in improving bank performance may be attributed to offsetting of any potential benefit of independence by cost of lack of expertise of independent directors (Ringe, 2013), or negative effect of perceived political connection of independent directors (Shi *et al.*, 2018). Thirdly, female participation in boards increase performance of banks, albeit insignificantly. BOD_FEM consistently has insignificant positive impact on both ROA and ROE with insignificant negative coefficient in model 5. Rouf and Hossain (2018) also reported insignificance of board gender diversity for ROA and ROE of Bangladeshi Banks. Bennouri *et al.* (2018) suggested that the mere presence of female directors in boards may not significantly improve firm performance unless female directors have specific monitoring and demographic attributes. In my opinion, the potential value generating role of female directors may also have been adversely affected by different

factors including their family affiliation as prior research (e.g. Mahbub *et al.*, 2019) found large number of banks in Bangladesh to be family dominated. Prior research (e.g. Bianco *et al.*, 2015) also indicates that female directors can be affiliated with dominant families in case of small firms.

4.3.2 Ownership structure and bank performance. The only independent variable found significant over all the models is institutional ownership. INS_OWN has highly significant negative impact on both ROA and ROE across the 6 models. Given the socio-economic context of ineffective governance in Bangladesh, this finding can be interpreted with reference to passive monitoring theory (Lin and Fu, 2017) whereby institutional shareholders, instead of being a mechanism of reducing agency cost and maximizing wealth for the common shareholders, may engage in speculative trades to gain in the short run. The result adds to the findings of Farooque *et al.* (2007) who found negative impact of institutional ownership on market to book value of equity in case of Bangladeshi listed firms.

H5 has been rejected. Director ownership is generally found to have insignificant positive impact on bank performance except in case of model 2 and 6. Insignificant negative impact of DIR_OWN has been found in the FE model for ROA (model 2) while statistically significant ($p < 0.10$) positive impact is found for GMM model for ROE (model 5). I therefore conclude that the relationship between DIR_OWN and bank performance is positive, albeit mostly insignificant. This finding contradicts with the results of Rouf and Hossain (2018) who found a significant positive influence of director ownership on both ROA and ROE of Bangladeshi Banks based on pooled OLS estimation and Farooque *et al.* (2007) who found inconsistently significant negative impact of director ownership on market to book value of shares of Bangladeshi firms. Difference of my findings with extant literature may be attributed to difference in dependent variables with Farooque *et al.* (2007), or difference in timeframe of datasets and inadequacy of statistical analysis of Rouf and Hossain (2018). In my opinion, contextual factors like family affiliation of directors (Habtoor, 2021), and different attributes of directors (Vafeas and Theodorou, 1998) may influence impact of director ownership on performance.

As expected from general perception (Aguilera *et al.*, 2021), and given the political context of Bangladesh, government ownership has consistently been found to have negative impact on bank performance. However, possibly due to token state-ownership, rejecting the H6, the coefficients are statistically insignificant. Statistically insignificant ($p = 0.9751$) positive coefficient of GOV_OWN has been found only in model 2. These results make me conclude that government ownership may have a negative impact on firm performance in developing economies with political instability where there is general lack of accountability of politicians and public officials. The negative coefficients of GOV_OWN could be statistically significant if government ownership was not tiny in the banks. The results are consistent with empirical study of Omran (2007) who found insignificant or negative influence of state-ownership on performance of privatized banks in Egypt.

4.3.3 Adding squares of ownership variables in the original equations. Following Farooque *et al.* (2007), I have also included squared institutional ownership in the models and found that squared institutional ownership has significant positive impact on ROA in OLS and GMM models, and on ROE in GMM model. In other models, the squared institutional ownership remains insignificant. Considering the higher efficiency of GMM in heteroskedastic situations (Lu and Wooldridge, 2019), I consider this finding to add with Farooque *et al.* (2007) that small institutional ownership can be value destructive as institutional investors may engage in speculative trades in such situation. But institutional owners may improve bank performance indicators if they have significant stake in the banks. Squared government ownership has been found to have significant negative impact on firm performance in the FE models. This indicates that performance of banks may reduce significantly when state has significant stake in banks. However, this issue needs further study. I have also investigated impact of squared director ownership on ROA and ROE and found no significant impact.

This indicates that role of directors in performance improvement does not change even if directors have significant stake in the banks.

5. Conclusion

In this study, given the unregulated socio-economic context of Bangladesh and based on the notion of new institutionalism, I tried to investigate whether board attributes and ownership structure affect firm value in Bangladesh. I drew my conclusion based on 140 firm-year observation from the banking sector of Bangladesh. The study finds that board attributes like board size, independence and gender diversity are insignificant predictor of both ROA and ROE of Banks. Ownership held by directors and government cannot significantly affect bank performance. However, institutional ownership has statistically significant negative impact on both ROA and ROE across all the 6 models. It would not be incorrect to state that the irrelevance of several governance mechanisms for improving bank performance may be attributed to mimicking developed country corporate governance mechanisms without proper understanding of the developing country socio-political context. The negative impact of institutional ownership on bank performance can be interpreted with reference to passive monitoring theory (Lin and Fu, 2017) which states that institutional shareholders, instead of focussing on improving performance of a firm, may engage in short-term profit making through speculative trades of shares. This may be specifically true in an unregulated, politicized financial environment attributed with inefficiency and family dominance during the high growth of a bank-based economy. However, additional analysis inconsistently finds significant positive impact of squared institutional ownership. This indicates that institutional owners may help improve performance if they have significant stake in the Bank. These findings have enormous implications for both global donor bodies like the World Bank, Asian Development Bank (ADB) etc. and the local regulators like Bangladesh Securities and Exchange Commission (BSEC). While irrelevance of Anglo-American governance mechanisms in emerging market context should bother international donor agencies, BSEC should closely monitor the roles of institutional owners with small stakes in secondary stock market anomalies. I also find several future research avenues. Firstly, a study on based on all listed firms in Bangladesh about value relevance of board attributes and ownership structure can help make firm decision whether Anglo-American governance mechanisms can improve overall firm performance in German-Japanese contexts. Findings based on all listed firms would be much more generalizable for all the developing economies. Moreover, it will clarify the role of institutional investors in the overall economy of Bangladesh during the span of economic expansion. Secondly, as discussed in the descriptive statistics section, institutional ownership in banks is increasing over time. However, the composition of higher institutional ownership is not quite clear. If share of institutional owners increases due to presence of large number of institutional investors with insignificant stakes, this may have adverse impact on performance of banks. The current study does not differentiate between local and international institutional investors as well. Future researchers can decompose the changes in institutional ownership over time to predict possible impact on bank performance. Thirdly, future researchers can identify suitable external instruments to be applied in dynamic panel models. This would help resolve the issue of endogeneity more robustly. Finally, as a new corporate governance code has been introduced in 2018, future studies can explore the existence of any structural break in corporate governance practices caused by the regulatory reform. Future researchers can also extend the timeframe of the study.

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