

## **The Impact of Corporate Governance on Nepalese Commercial Banks' Financial Performance**

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### **Abstract**

This research examines the impact of many bank-specific characteristics on the financial performance of listed commercial banks in Nepal, including board size, firm size, foreign ownership, and credit to deposit ratio. The panel data (70 observations) of 7 listed banks out of 27 banks was used to examine the determinants of banks' financial performance, such as ROE. The relationship and effect of the above-mentioned factors on the financial performance of commercial banks in Nepal were investigated using a correlational and causal research methodology in this study. This research discovered a link between board size, business size, foreign ownership, and credit-to-deposit ratio with financial performance. Again, the size of the board of directors, the size of the company, foreign ownership, and the credit-to-deposit ratio have all been found to have a major influence on financial success.

*Keywords:* board size, firm size, foreign ownership, credit deposit ratio, financial performance

### **Introduction**

#### **Background of the Study**

The process or act of ruling is referred to as governance. It is the method by which an organization is directed or controlled when it comes to a well-organized corporate sector. Corporate governance's relative efficacy significantly impacts a company's ability to succeed. Customers, employees, creditors, suppliers and distributors, the community, and owners all have obligations that must be honoured with honesty and by existing laws and regulations. Financial performance is the process of calculating the monetary value of an organization's policies and operations. Profitability, liquidity, and leverage are all indicators of these outcomes. Decision-makers can measure the results of business strategies and actions in objective monetary terms by evaluating a company's financial

performance. Normally, ratios are used to assess an organization's financial performance. Financial management that is well-designed and implemented is intended to contribute favourably to the creation of a company's value (Padachi, 2006). Internal and external variables influence a bank's financial performance. Internal factors are bank-specific elements that arise from the bank's operations and are represented in the bank's balance sheets and profit and loss accounts. External influences are not caused by a bank's activity, but rather represent the wider economic climate, which has an impact on the banking sector's financial performance. As a result, a bank's financial performance is largely determined by its activities (internal factors) as well as the broader performance of the economy (external factors).

Some global economic development and financial stability components need bank performance and efficiency, such as credit supply. To support a healthy financial system, authorities need banks to hold sufficient capital to absorb losses and reduce moral hazard behaviour (Fungáčová, Solanko, & Weill, 2014). Corporate governance is a collection of rules, processes, practices, laws, and institutions that influence how a corporation is managed and governed to improve commercial prosperity and accountability. Good company governance aims to reduce agency conflict (Bozec & Bozec, 2007). Corporate governance in banks may be different from that in other firms due to the existence of depositors in addition to shareholders and the intense level of government regulation in banks. As a result, it is suggested that a broader view of corporate governance be applied in the case of banks. Internal and external corporate governance procedures are used in bank corporate governance. Board size, board independence, and the number of board of directors are all internal corporate governance processes (Zabri, Ahmad, & Lean, 2015). The way authority is exerted over corporate organizations is referred to as corporate governance (Tricker & Tricker, 2015). Corporate governance was described by Cochran and Wartick (1988) as "...a broad word that encompasses a variety of challenges originating from interactions between senior management, shareholders, boards of directors, and other corporate stakeholders." The growing incidence of bankruptcies brought on by fraud or financial accounting mistakes in recent years has intensified the discussion of corporate governance. In those instances, divergent accounting techniques, a rise in personal interest, and skewed reporting were caused by a lack of corporate governance standards in the firms. Financial performance is a way of determining how well a business can use its assets to create income. It aids in determining the financial health of a company over time. By examining the balance sheet, income statement, and cash flow statement from the annual report, various analysts examine financial performance to compare a company's performance to that of other businesses in the same industry.

**Statement of the Problems**

Commercial banks serve an important intermediate function in fostering public trust and confidence among banking system participants. Because this is a highly trusted industry, any system flaws or governance failures will hurt public trust and the country's economic climate. For several years, Nepal has struggled to preserve macroeconomic stability. Low GDP, high unemployment, a large balance of payment deficit, a rising trade imbalance, and high and persistent inflation are just a few of the severe macroeconomic issues now facing the country. Now add the banking and liquidity crisis, which was mostly caused by the banks and financial institutions (BFIs) themselves, with some help from Nepal Rastra Bank, the central bank, and has had severe implications both within and beyond the banking sector.

The majority of previous empirical research on corporate governance, financial performance, and related concerns has used data from industrialized nations, mostly from US and UK companies. The literature on corporate governance in the United States and the United Kingdom emphasizes the function of the board of directors as a link between owners and management (Cadbury, 1992; Ward, 1997). Owners are unable to exert effective influence over the management or the Board of Directors in an atmosphere where ownership and management have grown widely separated. There has been very little study on developing nations, and the studies that have been done have mostly focused on the corporate governance environment, legislative measures, and their execution. Nepalese businesses are experiencing enormous hurdles in terms of survival, expansion, and profitability as a result of the dynamic and globalized economic climate. The vast majority of earlier empirical studies on corporate governance and financial performance took place in developed and emerging countries, however, there aren't many studies that delve in-depth into developing nations like Nepal. As a result, this research aims to examine the elements that influence the corporate governance and financial performance of Nepalese commercial banks. The following are the study's research questions:

- i. How does the board size of a company affect the financial performance of Nepalese commercial banks?
- ii. What effect does firm size have on the financial success of Nepalese commercial banks?
- iii. Does foreign ownership have an impact on the financial performance of Nepalese commercial banks?
- iv. Does the credit deposit ratio have an impact on the financial performance of Nepalese commercial banks?

**Research Objectives**

The overall goal of this research is to determine the characteristics that have a major impact on the financial performance of Nepalese commercial banks due to corporate governance. The following are the precise goals:

- i. To determine the impact of board size on Nepalese Commercial Banks' financial performance.
- ii. To investigate how the firm size influences Banks' financial performance.
- iii. To examine the impact of foreign ownership on Nepalese Commercial Banks' financial performance.
- iv. To determine the impact of the credit deposit ratio on Nepalese commercial banks' financial performance.

### **Research Hypothesis**

The purpose of this study is to see how corporate governance affects the financial performance of Nepalese commercial banks. Business size has a considerable (though small) beneficial effect on firm profitability. Kim, Tsui, and Yi, (2011) discovered that the size of an audit company had no impact on the quality of the audit. According to Farouk and Hassan (2014), auditor size and independence have a substantial influence on a firm's financial performance. The study produces the following hypothesis based on it. The following hypothesis has been presented for the study based on the aforementioned objectives:

*H<sub>1</sub>*: The board size has a positive influence on Nepalese commercial banks' financial performance.

*H<sub>2</sub>*: The firm size has a positive influence on Nepalese commercial banks' financial performance.

*H<sub>3</sub>*: Foreign ownership has a positive influence on Nepalese commercial banks' financial performance.

*H<sub>4</sub>*: The credit deposit ratio has a positive influence on Nepalese commercial banks' financial performance.

### **Limitations**

Every job has its own set of constraints that must be overcome to complete the assignment. Similarly, this study has several limitations that should not be overlooked. The following are some restrictions:

- i. Although corporate governance is a broad issue, this study is focused solely on the banking industry. As a result, the findings of this study may not apply to all industries.
- ii. Only accounting performance ROE and ROA are studied out of the several aspects of corporate governance performance.

### **Significance**

Corporate governance is a hot topic right now, and corporate scandals don't appear to be going away anytime soon. Because recent scandals may have resulted in a lack of confidence in today's corporations, it's critical to investigate how executive officers and senior managers see corporate governance in terms of the company's financial success. And how corporate governance principles affect accounting performance.

Because Nepalese understanding of corporate governance appears to be insufficient, research that might contribute to bridging the gaps in the country's knowledge of the subject is urgently needed. The purpose of this study is to see if the corporate governance concepts that researchers have shown to be important in explaining business success in industrialized nations apply to new banking and financial institutions in developing countries like Nepal.

### **Literature Review**

#### **Firm Size**

The companies' total assets are used to determine the size of an individual bank. Natural logarithms of total assets are used to calculate the size. Large enterprises have larger investment-cash flow sensitivity, according to Devereux and Schiantarelli (1990), Athey and Laumas (1994), and Vogt (1994). Major banks may engage in a wide range of businesses, allowing them to diversify their business portfolio and so reduce credit risk while increasing performance.

#### **Board Size**

The number of directors on a board is measured by its size. There are differing opinions about the size of the 'perfect' board. Both executive and non-executive directors should be on a board of directors. Lipton and Lorsch (1992) recommended an eight-to-nine-person board, whereas Leblanc and Gillies (2003) suggested an eight-to-eleven-person board. To establish a well-functioning board, the effective board size should be comprised of diversified knowledge and experience. Boards with too many directors may be ineffectual due to insufficient communication, resulting in an issue of directors' free riding. The efficiency of the board, rather than its size, should be the most important concern.

**Foreign Ownership**

Individuals who are not citizens of a nation or corporations with headquarters outside of that country own or control a company or natural resource in that country. According to Boardman, Shapiro, and Vining, (1997), foreign subsidiaries were more lucrative and productive than domestic subsidiaries. Foreign investors in Japan, according to Kang and Stulz (1997), tend to underweight smaller and highly indebted companies. Furthermore, they discovered that in companies with high export sales, stakes are significantly substantial. Gugler (1998) discovered a large and unfavorable link between profit margin and ownership concentration.

**Credit Deposit Ratio**

The percentage of loan assets that a bank generates from its deposits is known as the credit deposit ratio. Rashid et al. (2020) found a statistically significant connection between ROA and adiposity. ROE was not shown to be statistically significant, though. Indicators suggesting a positive relationship between capital-to-asset ratios and returns on equity were found by Berger (1995).

**Return on Equity (ROE)**

The Return on Equity (ROE) is a financial measure that compares a company's profit to the total amount of shareholder stock invested or located on the balance sheet. The return on investment (ROI) is what shareholders are looking for. A business that has a high return on equity is more likely to be able to generate its cash flow. As a result, the corporation produces profits more effectively the higher the ROE. In addition, ROE is defined by Khrawish and Al-Sa'di (2011) as the ratio of Net Income after Taxes to Total Equity Capital. It refers to the bank's investors' rate of return on their capital. The return on equity (ROE) measures how well a bank's management uses its shareholders' money. In light of the aforementioned assertion, one may contend that management is more adept at using shareholders' money when the ROE is greater.

It is widely understood that the principal-agent theory, which stems from Berle's (1932) famous thesis on *The Modern Corporation and Private Property*, is the beginning point for any discussion of corporate governance. The primary agency problem in modern organizations, according to this concept, is principally attributable to the separation of finance and management. Modern businesses are considered as having a separation of ownership and control, and as a result, they are operated by professional managers (agents) who are not answerable to dispersed shareholders. In this regard, ensuring that managers operate in the best interests of shareholders is crucial if we are to reduce the expenses related to the principal-agent theory. By emphasizing the numerous elements of a

corporation, the stakeholder theory appears to be more effective than the agency theory in describing the function of corporate governance. Creditors, consumers, workers, banks, governments, and the general public are all considered significant stakeholders. John and Senbet (1998) give a detailed analysis of the stakeholders' theory of corporate governance, which stresses the involvement of several parties with opposing interests in the firm's operations. This analysis is done in light of the discussion that came before it. They also emphasize how crucial non-market factors like board size and committee structure are in influencing a company's performance. Resource dependence theory, according to Hillman, Cannella, and Paetzold (2000), focuses on the function of directors in delivering or securing important resources to an organization through their ties to the external environment. Outside directors who are law firm partners give legal assistance, either in board meetings or in private communications with firm executives, that would otherwise be more expensive for the firm to get. The supply of resources has been suggested to improve organizational functioning, company performance, and survival. Executives and directors are motivated to administer the company to maximize financial performance and shareholder profits to safeguard their reputations as decision-makers in organizations. In this way, it is thought that the firm's performance has a direct influence on employees' judgments of their performance (Daily, Dalton, & Cannella Jr, 2003).

According to certain studies, the size of a bank's board of directors has a detrimental impact on its performance (Singh & Davidson, 2003). Gugler (1995) discovered a large and unfavorable link between profit margin and ownership concentration. Barbosa and Louri (2005) discovered that foreign investor ownership had a favorable and significant impact on business profitability. Amran (2011) investigated the relationship between corporate governance frameworks and firm performance experimentally. The board size, board independence, director qualification, director professional qualification, and leadership structure were utilized as corporate governance mechanisms; debt, firm age, firm size, and Tobin's Q were used as control variables. The hypothesis was tested using panel data methods and the generalized least square estimation method. Family-controlled businesses and non-family-controlled businesses made up the two groups of the sample. For non-family-owned enterprises, board size and leadership duality did not affect performance, but for family-owned businesses, they had a significant negative impact. The performance of family-owned and non-family-owned enterprises was significantly correlated with the firm age in both negative and positive ways, respectively. As opposed to that, both family-controlled and non-family-controlled enterprises had a strong negative association between company size and performance. For both types of businesses, additional variables such as board independence and director professional competence were unimportant. Al-Sahafi, Rodrigs, and Barnes (2015) investigate the link

between corporate governance characteristics and the financial performance of Saudi Arabia's publicly traded banks. This study's archive data includes the whole population of Saudi Stock Exchange-listed banks. Three financial performance indicators—ROA, ROE, and Tobin's Q—as well as other elements of corporate governance are used in the study (board size, independence, CEO status, audit committee, and ownership concentration). The results show that bank size, the board size, and board independence are all significantly positively correlated with bank financial performance, but ownership concentration and leverage ratio are significantly negatively correlated. However, the CEO's position, the size of the audit committee, and the independence of the audit committee have no bearing on a bank's financial performance. Rao and Desta (2016) investigate the impact of corporate governance on Ethiopian commercial banks' financial performance. Return on equity and return on asset is two proxies for financial success. Using an unweighted checklist, content analysis was used to determine the amount of disclosure. As a result, the ratio of a commercial bank's disclosure score to its total achievable score is used to determine the amount of disclosure practice. The relationship between corporate governance and financial success was also investigated using correlation and regression analysis. According to the research, the size of the board, the gender diversity on the board, and the type of ownership have no bearing on the financial performance of Ethiopian commercial banks. Asset size and capital structure, on the other hand, have a major impact on both the return on equity and the return on assets. The effect of corporate governance frameworks on the operation of Bangladeshi commercial banks is examined by Alam and Akther (2017). In this article, the board size, board independence, internal audit committee members, and capital adequacy ratio are utilized as four corporate governance metrics to measure bank performance. As dependent variables, we employ Return on Asset, Return on Equity, and Earnings per Share. The hypotheses in this study are investigated using correlation analysis and multiple regressions. The findings show that the number of independent directors, the size of the board of directors, and the size of the internal audit committee are all negatively correlated with bank performance. The regression analysis revealed a nonlinear association between the capital adequacy ratio and the other two performance measures, return on equity and profits per share, but a linear relationship between the capital adequacy ratio and return on asset. It might be because Bangladesh Bank is required by regulations to maintain an 8 percent CAR level to sustain the minuscule interest of depositors.

### **Materials and Methods**

The study's goal is to find out "whether there is a significant link between different factors, as well as if board size, firm size, foreign ownership, and credit to deposit ratio has



a major influence on return on equity?" It explains how hypotheses were investigated and the foundation on which conclusions were reached to important users. The impact of board size, firm size, foreign ownership, and credit to deposit ratio on return on equity of selected commercial banks in Nepal is the subject of this study. To evaluate the study's goal, researchers employed a correctional and causal research design. It is based on confidential data obtained from selected banks' annual reports. For the study, sample banks were Everest Bank Ltd. (EBL), Nepal SBI Bank Ltd. (NSBIBL), Standard Chartered Bank Nepal Ltd. (SCBNL), Nabil Bank Ltd. (NABIL), NMB Bank Ltd. (NMBBL), Nepal Bangladesh Bank Ltd. (NBBL), and Himalayan Bank Ltd. (HBL). Out of twenty-seven commercial banks in Nepal, the banks were picked as a deliberate strategy. For analysis, the study analyzed data from the previous ten years.

**Results and Discussion**

This section of the research calculates the link between board size (BS), firm size (FS), foreign ownership (FO), credit deposit ratio (CDR) with return on equity (ROE) for EBL, NSBIBL, SCBNL, NABIL, NMBBL, NBBL, and HBL. Another part of the analysis looks at the impact of firm size, board of directors, foreign ownership, and credit deposit ratio on the ROE of EBL, NSBIBL, SCBNL, NABIL, NMBBL, NBBL, and HBL using regression analysis, with ROE as the dependent variable and firm size, board of directors, foreign ownership, and credit deposit ratio as the independent variables.

**Table 1**

*Correlation Analysis*

Variables	ROE	BS	FS	FO	CDR
ROE	1				
BS	.782**	1			
FS	.884**	-.702*	1		
FO	.890**	-.601	.890**	1	

CDR	.750**	.830	.570*	.750*	1
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\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

Table 1 shows that the correlation between board size, firm size, foreign ownership, and credit deposit ratio of EBL, NSBIBL, SCBNL, NABIL, NMBBL, NBBL, and HBL with return on equity (ROE) is 0.782, 0.884, 0.890, and 0.750, respectively, all of which are high degree positive correlations indicating that the variables have the same direction changing relationship and the coefficients are significant in the population at the 5% and 1% level. These significant coefficients imply that the relationship between board size, company size, foreign ownership, and credit deposit ratio of sample banks and return on equity of the population is substantial.

**Table 2**

*Model summary of all variables*

Model	R	R <sup>2</sup>	Adjusted R <sup>2</sup>	Std. Error of Estimate
1	.966	.933	.879	2.04778

Predictors: (Constant), BS, FS, FO, and CDR

The R-square, also known as the coefficient of determination, is used to explain variation in the model summary. As shown in Table 2, the R-square value is .933, implying that BS, FS, FO, and CDR account for 93.3 percent of the variation in the financial performance of Nepalese commercial banks (ROE). The remaining 6.7 percent, however, remains unexplained in this study. To put it another way, other factors explain the financial performance of Nepalese commercial banks that were not taken into account in our study.

Similarly, after modifying the degree of freedom, the adjusted R-square is 0.879, implying that BS, FS, FO, and CDR explain 87.9 percent of bank performance in Nepalese commercial banks. The standard error of the estimate of 2.04778 is also shown in the model summary, indicating the variability of the observed value of Nepalese commercial banks' financial performance.

**Table 3**

*ANOVA of all Variables*

Model	Sum of Squares	df	Mean Square	F	Sig.
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1	Regression	280.375	4	70.094	19.345	.003
	Residual	18.854	5	3.771		
	Total	299.229	9			

Dependent Variable: ROE

Predictors: (Constant), BS, FS, FO, and CDR

Table 3 shows that the F value is 19.345 and the p-value is 0.03 (smaller than alpha), indicating that independent factors influence Nepalese commercial bank performance.

**Table 4**

*Regression Analysis for Dependent Variable ROE*

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	120.864	51.366		2.353	.004
	BS	2.802	.8377	.105	3.345	.002
	FS	1.246	.4714	.562	2.643	.036
	FO	0.112	.0495	.237	2.263	.001
	CDR	2.346	.6484	.240	3.618	.026

Over the study period, Table 3 shows the regression analysis results for the dependent variable ROE and the independent variables board size, company size, foreign ownership, and credit deposit ratio for EBL, NSBIBL, SCBNL, NABIL, NMBBL, NBBL, and HBL. Board size, firm size, foreign ownership, and credit deposit ratio had beta coefficients of 2.802, 1.246, 0.112, and 2.346, respectively, indicating that bank ROE is positively related to board size, firm size, foreign ownership, and credit deposit ratio. The coefficients are significant at 5% because the p-values of the independent variables' coefficients, 0.002, 0.036, 0.001, and 0.026, are less than the 5% level of significance.

### Discussion

The research aids in determining the impact of board size, firm size, foreign ownership, and credit deposit ratio on Nepalese commercial banks' financial performance. A total of 70 observations were used to create the sample. This study is based on secondary data gathered from the websites of the different banks and the National Reserve Bank. Four independent variables, namely BS, FS, FO, and CDR, are employed in this

study, as well as one dependent variable, bank performance as assessed by ROE. Rao and Desta (2016) discovered that while board size and ownership type have minimal influence on profitability, asset size and capital structure have a considerable impact, and the link is linear. Board size, board independence, and bank size all have a strong positive association with bank financial performance, according to Al-Sahafi, Rodrigs, and Barnes (2015), whereas ownership concentration and leverage ratio have a significant negative relationship. The position of the CEO, the size of the audit committee, and the audit committee's independence, on the other hand, have little influence on a bank's financial performance. Similarly, in this study, the board size, company size, foreign ownership, and credit-to-deposit ratio have a substantial beneficial influence on the performance metric ROE of Nepalese commercial banks.

### **Conclusion**

The banking business is without a doubt one of the most heavily regulated in the world. In the global setting, bankers believe that corporate governance is critical to a bank's success. The relationship between board size, firm size, foreign ownership, and credit to deposit ratio with financial performance (ROE) of Nepalese commercial banks is positively correlated, according to the correlation analysis. It means that the variables have the same direction-changing connection and that the coefficients are statistically significant at the 5% and 1% levels. These significant coefficients suggest that there is a significant association between board size, firm size, foreign ownership, and credit deposit ratio of sample banks and population return on equity. The findings also reveal that board size, firm size, foreign ownership, and credit deposit ratio have a substantial influence on the bank performance (ROE) of Nepalese commercial banks, implying that the performance of the chosen banks increases as the independent variables improve.

### **Implications**

Banks in Nepal should be mindful that their board size, firm size, foreign ownership, and credit deposit ratio all have an impact on their success. Larger banks make more money because they can distinguish their goods and diversify their risks, allowing them to compete in less competitive markets. This is mostly a result of Nepalese commercial banks. Future studies might undertake this sort of research on other financial institutions such as development banks, financial businesses, and so on to see how capital regulation affects their financial success. Similarly, advanced statistical tools can be used to conduct additional research. Future research might, for example, make use of non-linear statistical methods and causality tools. This research is entirely based on secondary data.

As a result, by employing primary sources such as surveys, questionnaires, and special group discussions, future research can become more thorough. Future research can take into account the qualitative phenomena. Other capital requirements imposed by the central bank, such as the spread rate, bank rate, statutory liquidity ratio, and leverage ratio, have an impact on the financial performance of banks.

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