Impact of Board Independence on the Performance of Nepalese Commercial Banks

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Abstract

This study analyzes how board independence influences financial performance and operational efficiency in Nepalese commercial banks, focusing on governance practices, strategic decision-making, and regulatory compliance. A mixed-methods design was used, combining quantitative analysis of financial data from Nepalese banks with qualitative insights from interviews with industry experts. Metrics like ROA, ROE, and cost-to-income ratios assessed the impact of board independence. Greater board independence is positively correlated with improved financial performance and operational efficiency. Banks with more independent boards showed better ROA, ROE, and cost-to-income ratios, along with enhanced governance quality. Board independence is crucial for enhancing the performance of Nepalese banks, contributing to better governance, financial metrics, and decision-making. Optimizing board structures can improve governance outcomes in emerging markets. This study expands the limited literature on board independence in Nepalese banks, providing both quantitative and qualitative insights. It offers practical implications for policymakers to optimize board composition for better performance.

Keywords: *Board Independence, Operational Efficiency, Commercial Bank, Corporate Governance and Accountability.*

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Background

Board independence is crucial for effective corporate governance, particularly in financial institutions where impartial oversight and decision-making are essential (CSR Journal, 2020). Independent directors are integral in overseeing management and ensuring decisions are made in the best interest of shareholders. Their presence helps mitigate conflicts of interest, enhances accountability, and fosters better strategic decision-making (Poudel & Hovey, 2013). In Nepal, the emphasis on board independence has grown due to recent regulatory reforms aimed at strengthening governance standards in the banking sector.

The Nepalese banking sector has been under scrutiny for its governance practices, with recent reforms focusing on increasing the number of independent directors on bank boards. These reforms are intended to enhance the effectiveness of oversight and improve financial performance. However, there is limited empirical research assessing the actual impact of board independence on the performance of Nepalese banks.

Problem Statement

While board independence is widely recognized as a crucial element in enhancing corporate governance, there is a notable gap in research concerning its specific impact within the context of Nepalese banks. Existing studies largely focus on broader corporate settings, leaving a void in understanding how board independence directly affects the performance of banks in Nepal.

This study seeks to address this gap by investigating how varying levels of board independence influence the financial performance and operational efficiency of Nepalese commercial banks. By focusing on this under-researched area, the study aims to provide valuable insights into the role of independent board members in the banking sector and their implications for governance and performance. The research explores the impact of board independence on overall performance, financial metrics such as Return on Assets (ROA) and Return on Equity (ROE), as well as operational efficiency and strategic decision-making within Nepalese commercial banks.

The study aims to determine the influence of board independence on financial performance, evaluate its effect on operational efficiency and governance practices, and provide recommendations for enhancing board independence to improve bank performance and governance in Nepal. Understanding how governance structures affect financial outcomes and operational efficiency is crucial for policymakers and regulators seeking to improve the performance of the Nepalese banking sector (Rajagopalan & Zhang, 2009).

Literature Review

Conceptual Review

Board independence refers to the presence of directors on a company's board who are not part of the management team and do not have significant ties to the firm. The purpose of having independent directors is to provide unbiased oversight, reduce conflicts of interest, and improve decision-making (Adams et al., 2008). In the banking sector, board independence is particularly important, as banks require robust governance to manage financial risks and protect depositors' and shareholders' interests. Independent directors help ensure that decisions are made in a transparent and accountable manner, mitigating potential conflicts between management and shareholders.

Theoretical Review

The relationship between board independence and firm performance is grounded in agency theory. According to this theory, a firm's management may act in its own interest rather than in the best interest of shareholders. Independent directors help align management's actions with shareholder interests by providing objective oversight and reducing agency costs (Jensen & Meckling, 1976). The resource dependence theory also supports the presence of independent directors, suggesting that they bring valuable resources, expertise, and external connections that can enhance the firm's strategic decisions (Hillman, Cannella, & Paetzold, 2000). Additionally, stewardship theory argues that independent directors play a key role in ensuring that corporate governance systems are geared towards sustainable growth and long-term value creation.

Empirical Review

Globally, empirical studies have shown a strong link between board independence and improved financial performance. Adams, Hermalin, and Weisbach (2008) found that firms with a higher proportion of independent directors experience better financial performance, citing more effective management oversight. Bhagat and Bolton (2008) also found that independent boards correlate with higher shareholder value and better governance practices. Beasley (1996) demonstrated that companies with more independent directors experience fewer financial restatements, indicating stronger financial reporting and governance.

In the context of Nepal, recent studies have produced similar findings. Panta and Koirala (2024) showed that Nepalese banks with a higher proportion of independent directors reported better financial outcomes, including higher ROA and ROE. Kumar and Sharma (2023) found that board independence is linked to improved operational efficiency, with lower cost-to-income ratios among banks with more independent directors. These empirical findings underline the importance of independent directors in enhancing both financial and operational performance in Nepalese commercial banks.

Numerous studies have highlighted the positive correlation between board independence and improved financial performance. Adams, Hermalin, and Weisbach (2008) argue that independent directors enhance oversight and decision-making processes, leading to better financial outcomes. Independent directors are less likely to be influenced by management and thus provide more objective oversight. This impartiality helps in reducing agency costs and aligning managerial actions with shareholder interests.

Gompers, Ishii, and Metrick (2009) found that firms with a higher proportion of independent directors exhibit higher market valuations and financial performance. They attribute this to reduced agency costs and better governance practices, which contribute to more effective management and strategic decision-making. Similarly, a study by Bhagat and Bolton (2008) showed that boards with a greater number of independent directors are associated with higher shareholder value and better financial performance.

Research has also shown that independent directors contribute to improved financial reporting and risk management. Beasley (1996) demonstrated that firms with independent directors are less likely to experience financial restatements, indicating more reliable financial reporting. This is crucial for maintaining investor confidence and ensuring transparency. Jensen (1993) emphasized that independent directors are better positioned to oversee risk management, reducing the likelihood of significant financial losses and enhancing overall firm stability.

In Nepal, recent research has indicated that board independence positively impacts financial performance and risk management in banks. Panta and Koirala (2024) found that banks with a higher proportion of independent directors tend to achieve better financial outcomes, such as higher return on assets (ROA) and return on equity (ROE). Their study highlights that independent directors contribute to better risk management and financial stability, which are critical for the health of the banking sector.

Similarly, Kumar and Sharma (2023) found that board independence is positively associated with improved operational efficiency in Nepalese banks. Their research shows that banks with more independent directors have lower cost-to-income ratios, suggesting more effective resource management and cost control. This is consistent with global findings and underscores the importance of independent directors in enhancing operational efficiency.

Despite these findings, there remains a need for more detailed research on how board independence affects different aspects of banking performance in the Nepalese context. This study aims to provide a comprehensive analysis of the relationship between board independence and various performance indicators in Nepalese commercial banks.

Based on these discussion, the following hypotheses were developed to test:

H_1: There is a positive relationship between board independence and the overall financial performance of Nepalese commercial banks.

This hypothesis suggests that increased board independence is associated with improved financial metrics such as Return on Assets (ROA) and Return on Equity (ROE).

H_2: Board independence has a significant impact on the operational efficiency of Nepalese commercial banks.

This hypothesis posits that greater board independence enhances operational efficiency, potentially through better governance practices and strategic decision-making.

H_3: Board independence positively influences strategic decision-making in Nepalese commercial banks.

This hypothesis implies that a higher level of board independence leads to more effective and strategic decision-making processes within the banks.

H_4: The level of board independence is positively correlated with improved governance practices in Nepalese commercial banks.

This hypothesis suggests that increased board independence is linked to better governance practices, which in turn affect the overall performance of the banks

Research Gap

Despite the existing research, there is a significant gap in understanding the detailed impact of board independence on various performance indicators in Nepalese commercial banks. Previous studies have primarily focused on broader financial outcomes or specific aspects of governance without providing a detailed analysis of how board independence influences different performance metrics. This study seeks to address this gap by providing a more nuanced examination of the relationship between board independence and banking performance.

Research Methods

A mixed-method approach was employed to investigate the impact of board independence on the performance of Nepalese commercial banks. This approach combined both quantitative and qualitative data to provide a comprehensive view of the research problem.

Data Collection

Quantitative data was collected through surveys administered to 150 employees across five major commercial banks in Nepal. The survey included questions related to board composition, financial performance metrics, and operational efficiency indicators. Employees were asked to provide information on the proportion of independent directors on their banks' boards and to rate the impact of board independence on various aspects of bank performance.

Qualitative data was gathered through semi-structured interviews with board members, executives, and independent directors. These interviews provided insights into the role of independent directors in decision-making processes, their influence on governance practices, and their impact on banking performance. The qualitative data helped to contextualize the quantitative findings and provide a deeper understanding of the mechanisms through which board independence affects performance.

Data Analysis

The data was analyzed using descriptive statistics, Pearson correlation, and regression analysis. Descriptive statistics provided an overview of the sample characteristics, including the average proportion of independent directors and the financial performance metrics of the banks. Pearson correlation analysis was used to assess the relationship between board independence and performance indicators, while regression analysis determined the impact of board independence on specific performance metrics, such as ROA, ROE, and cost-to-income ratio.

Descriptive statistics revealed that the average proportion of independent directors on bank boards in the sample was 20%. Banks with a higher percentage of independent directors demonstrated better financial performance and operational efficiency. Pearson correlation analysis indicated a strong positive correlation between board independence and financial performance ($r = 0.67$, $p < 0.01$). Regression analysis showed that board independence is a significant predictor of both ROA ($\beta = 0.43$, $p < 0.05$) and ROE ($\beta = 0.38$, $p < 0.05$). Additionally, board independence negatively impacted the cost-to-income ratio ($\beta = -0.29$, $p < 0.05$), suggesting that banks with more independent directors are more operationally efficient.

Results and Findings

Descriptive Statistics

The descriptive statistics revealed that the average proportion of independent directors on bank boards in the sample was 20%. Banks with a higher percentage of independent directors demonstrated better financial performance and operational efficiency. Specifically, banks with more independent directors had higher ROA and ROE and lower cost-to-income ratios. This suggests that a higher proportion of independent directors is associated with improved financial metrics and greater operational efficiency.

Table 1

Impact of Board Independence on Bank Performance Metrics (Sample Data from 5 Major Nepalese Commercial Banks)

Performance Metric	Banks with Low Board Independence (<15%)	Banks with High Board Independence (>25%)
Return on Assets (ROA)	0.85%	1.45%
Return on Equity (ROE)	7.20%	10.50%
Cost-to-Income Ratio	60%	50%
Risk Management Score	3.2/5	4.5/5
Operational Efficiency	Moderate	High

Correlation Analysis

Pearson correlation analysis indicated a strong positive correlation between board independence and financial performance ($r = 0.67$, $p < 0.01$). This finding supports the hypothesis that greater board independence is associated with improved financial performance. The positive correlation between board independence and financial metrics such as ROA and ROE underscores the importance of independent oversight in enhancing bank performance.

Table 2

Correlation Analysis between Board Independence and Banking Performance Metrics

Variables	Board Independence	Return on Assets (ROA)	Return on Equity (ROE)	Cost-to-Income Ratio
Board Independence	1	0.67**	0.65**	-0.58**
Return on Assets (ROA)	0.67**	1	0.72**	-0.45**
Return on Equity (ROE)	0.65**	0.72**	1	-0.51**
Cost-to-Income Ratio	-0.58**	-0.45**	-0.51**	1

Note: $p < 0.01$ level of significance

The correlation between board independence and ROA is 0.67**, indicating a strong positive relationship. This means that higher board independence is associated with better ROA, suggesting that more independent boards contribute to increased profitability relative to assets. Similarly, the correlation between board independence and ROE is 0.65**, also reflecting a strong positive association. This implies that greater board independence tends to enhance profitability from the shareholders' perspective.

Conversely, the relationship between board independence and the Cost-to-Income Ratio is -0.58**, showing a significant negative correlation. This indicates that as board independence increases, the cost-to-income ratio decreases, pointing to improved operational efficiency. More independent boards are linked to reduced operational costs relative to income.

The correlations between ROA and ROE (0.72**) and between ROA and the Cost-to-Income Ratio (-0.45**) suggest that banks with higher ROA also tend to have higher ROE and lower costs relative to income. The correlation between ROE and the Cost-to-Income Ratio is -0.51**, indicating that banks with higher ROE generally experience lower costs relative to income.

Overall, the correlations reveal that board independence positively impacts profitability metrics (ROA and ROE) while negatively affecting the Cost-to-Income Ratio, demonstrating that independent boards are associated with both higher profitability and greater efficiency in managing operational costs.

Regression Analysis

Regression analysis showed that board independence is a significant predictor of both ROA ($\beta = 0.43$, $p < 0.05$)

and ROE (β = 0.38, $p < 0.05$). This indicates that banks with a higher proportion of independent directors tend to achieve better financial outcomes. Additionally, board independence negatively impacted the cost-to-income ratio (β = -0.29, $p < 0.05$), suggesting that banks with more independent directors are more operationally efficient. These findings highlight the positive impact of board independence on both financial performance and operational efficiency.

Table 3

Regression Analysis of Board Independence on Financial Performance Metrics

Dependent Variable	Independent Variable	Beta Coefficient (β)	t-value	p-value	R^2	Adjusted R^2
Return on Assets (ROA)	Board Independence	0.43*	3.15	0.002	0.45	0.43
Return on Equity (ROE)	Board Independence	0.38*	2.95	0.005	0.42	0.41
Cost-to-Income Ratio	Board Independence	-0.29*	-2.57	0.01	0.34	0.33

*Note: *p < 0.05 level of significance*

Return on Assets (ROA)

The regression analysis indicates that board independence has a positive and significant effect on Return on Assets (ROA). The beta coefficient of 0.43 reveals that for each 1-unit increase in board independence, ROA increases by 0.43 units. This positive relationship suggests that banks with a more independent board tend to achieve higher profitability relative to their assets. The t-value of 3.15 supports the statistical significance of this effect, as it exceeds the conventional threshold of 2, indicating that board independence has a meaningful impact on ROA. The p-value of 0.002 further confirms the significance of this relationship, being well below the 0.05 level. The R^2 value of 0.45 means that 45% of the variation in ROA can be attributed to board independence, and the adjusted R^2 of 0.43, which accounts for the number of predictors and sample size, shows that 43% of the variability in ROA is still explained by board independence after these adjustments. This finding underscores the importance of board independence in enhancing the profitability of banks as measured by ROA.

Return on Equity (ROE)

Similarly, board independence positively influences Return on Equity (ROE). The beta coefficient of 0.38 indicates that a 1-unit increase in board independence leads to a 0.38 unit increase in ROE, suggesting that more independent boards contribute to better profitability from the shareholders' perspective. The t-value of 2.95 highlights the statistical significance of this effect, with a value greater than 2 suggesting a meaningful impact. The p-value of 0.005 confirms that this relationship is statistically significant at the 5% level. The R^2 value of 0.42 implies that 42% of the variation in ROE is explained by board independence, and the adjusted R^2 of 0.41 indicates that this proportion remains substantial after adjusting for the number of predictors. This result reinforces the notion that greater board independence enhances profitability from the shareholders' perspective, as reflected by ROE.

Cost-to-Income Ratio

In contrast, board independence has a negative relationship with the Cost-to-Income Ratio, as evidenced by the beta coefficient of -0.29. This negative coefficient suggests that as board independence increases, the cost-to-income ratio decreases, indicating improved operational efficiency. A t-value of -2.57 supports the statistical significance of this inverse relationship, with the negative sign indicating that greater board independence is associated with lower operational costs relative to income. The p-value of 0.01 confirms this significance at the 5% level. The R^2 value of 0.34 indicates that 34% of the variation in the cost-to-income ratio can be explained by board independence, while the adjusted R^2 of 0.33 suggests that 33% of the variability remains accounted for even after adjusting for the number of predictors. This finding highlights that more independent boards contribute to greater efficiency in managing operational costs relative to income.

Discussion

Impact of Board Independence on Financial Performance

The study's findings align with global research, demonstrating that board independence positively affects financial performance. Banks with a higher proportion of independent directors show higher ROA and ROE, reflecting more effective oversight and management. This is consistent with the work of Adams, Hermalin, and Weisbach (2008), who found that independent directors improve financial performance by providing unbiased oversight and reducing agency costs.

In the context of Nepal, where banking governance has been under scrutiny, the role of independent directors is crucial. The findings support the view that independent directors help mitigate risks associated with concentrated ownership and ensure that decisions are made in the best interest of shareholders (Panta & Koirala, 2024). The positive impact of board independence on financial performance underscores the need for effective governance practices in the Nepalese banking sector.

Impact of Board Independence on Operational Efficiency

The study also found that board independence enhances operational efficiency, with banks having lower cost-to-income ratios. This indicates that independent directors contribute to more effective resource management and cost control. The finding aligns with Kumar and Sharma (2023), who reported that independent directors improve operational efficiency in Nepalese banks. The ability of independent directors to oversee management and ensure efficient use of resources contributes to lower operational costs and improved performance.

Implications for Corporate Governance in Nepalese Banks

The results underscore the importance of board independence for improving both financial performance and operational efficiency in Nepalese banks. Policymakers and regulators should consider promoting or mandating higher levels of board independence to strengthen governance and enhance banking sector performance. Strengthening governance practices through increased board independence can lead to better financial outcomes and operational efficiency, ultimately benefiting shareholders and the broader economy.

Conclusion

Board independence plays a critical role in enhancing the performance of Nepalese commercial banks. The presence of independent directors is positively associated with better financial outcomes and operational efficiency. The study provides empirical evidence supporting the importance of independent oversight in ensuring effective governance and protecting shareholders' interests. By improving financial performance and operational efficiency, board independence contributes to the overall stability and success of Nepalese banks.

Limitations and Recommendations for Further Research

Limitations

Geographical Focus: The study focused on banks located in the Kathmandu Valley, which may not fully represent the diversity of the Nepalese banking sector. Banks in other regions may have different governance practices and performance outcomes.

Sample Size: The sample size of 150 employees may limit the generalizability of the findings to the broader banking sector. A larger sample could provide more robust insights into the relationship between board independence and performance.

Recommendations

Broader Geographic Scope: Future research should extend beyond the Kathmandu Valley to include banks from other regions of Nepal. This would provide a more comprehensive understanding of the impact of board independence across different banking environments and enhance the generalizability of the findings.

Larger Sample Size: Increasing the sample size could enhance the robustness of the findings and allow for more detailed analysis of the relationship between board independence and various performance indicators. A larger sample would provide more reliable data and improve the accuracy of the results.

Exploration of Other Governance Variables: Further studies should investigate the impact of other governance variables, such as executive compensation, board diversity, and regulatory compliance, on banking performance. Understanding how these factors interact with board independence can provide a more complete picture of corporate governance and its effects on performance.

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