Corporate Governance and Performance of Financial Institutions in Pakistan:

A Comparison between Conventional and Islamic Banks in Pakistan

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INTRODUCTION

Corporate Governance refers to the way an organization is directed, administrated or controlled. It includes the set of rules and regulations that affect the manager's decision and contribute to the way company is perceived by the current and potential stakeholders. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as; boards, managers, shareholders and other stakeholders and spells out the rules and procedures and also decision making assistance on corporate affairs. By doing this, it also provides the structure through which the company's objectives are set and the means of obtaining those objectives and monitoring performance. Corporate governance may be the ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors.

Effective corporate governance mobilizes the capital annexed with the promotion of efficient use of resources both within the company and the larger economy. It also assists in attracting lower cost investment capital by improving domestic as well as international investor's confidence. Good corporate governance ensures the accountability of the management and the Board. The Board of directors will also ensure legal compliance and take impartial decisions for the betterment of the business. It is understood that efficient corporate governance will make it difficult for corrupt practices to develop and take root, though it may not eradicate them immediately.

Corporate governance swivel around some important aspects such as Role of board of directors, Basic structure of board of directors, its remuneration, Ownership of director, Availability of freedom to an enterprise, Role of services of institutional directors, Accountability of member of BoD, Financial reporting, Institutionalization of audit functions and Linkage with shareholders. Good corporate governance can add value to developing sound corporate management and enriching the results of corporate entities for society in general and shareholders in particular to be the beneficiaries.

The developed countries like US, UK, Germany, Hong Kong and etc have developed different models of corporate governance which now implemented there in true spirit. The World Bank also showed interest in this topic and developed a World Governance Index (WGI). The objective of this index is to evaluate the corporate performance of different countries on the basis of Regulations, Corruption and Rule of Law. The results of the index showed that the performer in corporate governance was Germany with a score of 90.8% and worst performer is Bangladesh with a score of 24.3.

Given the state of the economy of Pakistan in 2010, troubled as it is; ideally it would be more desirable to look at the governance issues at macro level for Pakistan. The financial and administrative turn-around of eight loss-making public sector entities is the biggest challenge for the government to improve governance and put national economy back on track. As a famous economist, Dr Shahid Javaid Burki- a long observer of Pakistan's economy has recently stated *"Pakistan can generate a greater bounce in its economy than India by creating better* *governance. It has occurred before in the country's difficult economic history and could happen again." (Improved Governance: Dawn, 12^{th}, October 2010).*

However, as a starting point, in this paper we look at closely the governance issues for the financial sector, a sector which has played a significant role till recent years in economic activity of Pakistan. Rehman et al (2010) have looked at the issue of corporate governance in Chemical and Pharmaceutical sectors of Pakistan and found that there is a significant impact of corporate governance on the shareholder's returns in pharmaceutical sector of Pakistan. Corporate governance has become an issue of global significance. The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations. In Pakistan, the first Code of Corporate Governance for Pakistan was finalized and issued by SECP in March 2002. Then it was subsequently incorporated in all the listed companies of three stock exchanges in Pakistan. In 2004, SECP took the first step to establish the Pakistan Institute of Corporate Governance in public private partnership.

According to" A Survey of Corporate Governance Practices in Pakistan, 2007", conducted by: International Finance Corporation and SECP, 92% respondents prepare annual "statement of Ethics and Business Policy", 48% had "vision and Mission Statement", and none of the respondents have Code of Corporate Governance. On the other hand, it was also found that 50% of the corporations in Pakistan did not include non-executive directors in their board of directors, 54% have not introduced transaction administration procedure, 53% have not implement a formal remuneration system, and 55% did not have corporate governance improvement plan. Whereas, 31% respondents did not identify the barriers to improve the corporate governance, 69% identified the barriers, 42% had non availability of qualified staff to implement and 21% did have the claim that corporate governance produces sensitive information that cannot be shared with the competitors.

Even though many studies have conducted on corporate governance issues in the non-financial sectors, a few studies examine the corporate governance issues in the banking sector (Wright et al., (2002), Kinti et al. (2004), Berger et al (2005)). This paper focuses on corporate governance impact on financial sector of Pakistan.

Literature Review

Several empirical studies have investigated the association between corporate governance and firm performance (Yermack, 1996; Claessens et al., 2000; Klapper and Love, 2002; Gompers et al., 2003; Black et al., 2003; Sanda et al., 2005), with inconclusive results. Adjaoud et al. (2007) concluded that there is little evidence of a systematic relationship between the characteristics of the board. Bhagat et al (2000) and Weir et al (1999) experienced a positive relationship between corporate governance and firm performance. Albeit Eisenberg et al (1998) observed a negative relationship between them.

Corporate governance contains various aspects of complex regimes as Zingales (1998) also examines it as a comprehensively broad, multifaceted notion that is enormously relevant, while difficult to define, due to the variety of scope that it encompasses. Friend and Lang (1998) examine that shareholders, having high concentration in firms, play an important role to control and direct the management to take keen interest in benefit of the concentration group. In addition corporate governance regimes also allow shareholders to direct the management for betterment of their investment. Shleifer et al (1997) describe that concentration groups with large share holdings; check the manager's activities better.

However, the check and balance not only causes to reduce the agency cost but also resolves the issues between managers and owners. Furthermore, Williamson (1988) examined the relationship between corporate governance and securities. Jensen (1986) seems to be quite keen to analyze how corporate governance directly or indirectly influences the capital structure and firm value. While, Driffield et al., (2007) found that higher ownership concentration has a positive impact on capital structure and firm value. In the case of lower ownership concentration, the relationship depends upon the strictness of managerial decision making which enforce to bring change in the capital structure.

For the US market, Gompers et al. (2003) analyzed the relationship between corporate governance, long-term equity returns, firm value and accounting measures of performance, while Rob Bauer et al. (2004) found combined relationship between corporate governance, firm value and equity returns. Substantial differences are found between the UK market and the Euro-zone markets. Many studies prove that there is no linkage between corporate governance and performance. Beth (2003) concluded that there is no impact of director independence on firm performance. Several studies have been conducted so far and still going on to examine the relationship between firm performance and corporate governance mechanisms, but the results are mixed (Kajola et al, 2008). Anthony et al (2007) observed that the sector and country has a significant effect while examining the impact of corporate governance on firm performance.

According to Maria Mahar and Thomas Anderson (2008) there are some weaknesses, strengths and economic implications associated with corporate governance systems. It is widely believed that good corporate governance is an important factor in improving the value of a firm in both developing and developed financial markets. However, the relationship between corporate governance and the value of a firm differs in emerging and mature financial markets due to disparate corporate governance structures in these markets resulting from dissimilar social, economic and regulatory conditions in these countries. There is a need to understand the differences which affect the value of a firm for academic investigations, financial and management practices and public regulation of corporations and markets. The variables used by Kashif Rashid (2008): price to book value ratio, market capitalization, gearing ratio, return on total assets, shareholder's concentration (agency cost), CEO duality, board size, and judicial and regulatory authority efficiency. Burki and Ahmad (2007) explored the changes of corporate governance in Pakistan's banking sector and its impact on their efficiencies.

For measuring corporate governance different variables are used by the researchers such as Board Size, Board Independence, Board meeting, Ownership structure, Family Ownership and Dual role of CEO. A widely debated corporate governance issue is whether the two most important positions in a company - the Chairman of the Board and the CEO – should be held by two different individuals (a dual leadership structure) or one person may be assigned both portfolios (a unitary leadership structure).

Many studies addressed the CEO duality-performance relationship; with inconsistent results (Brian K. Boyd 1994) .There is only weak evidence that duality status affects long-term performance, after controlling the other factors that might impact the performance. (B. Ram Baliga et al., 1995). Berg et al (1978) and Brickley et al (1997) concluded that there is a chance of agency cost when CEO performs dual role. Therefore, the separation of the two positions enhances shareholder value. Fama et al (1983) also argued that concentration of decision management and decision control in one individual reduces a board's effectiveness in monitoring top management. For example, when a CEO doubles as board chairman, this results in conflict of interests and increases agency costs.

A number of empirical studies have been conducted in the US to measure the impact of director independence and corporate performance. Some researchers found a direct evidence of a relationship between board composition in terms of independence and corporate performance. Kesner (1987), studying Fortune 500 companies found a positive and significant correlation between proportion of inside directors and two indicators of performance: profit margin and return on assets.

Baysinger et al (1985) and Hambrick et al (2000) found evidence for the proportion of independent non-executive directors to be positively correlated with the accounting measure of performance. On the other hand, studies by Klein (1998), Bhagat et al (1997), and Hermalin et al (1991) experienced a high proportion of independent directors does not predict a better future accounting performance. Using accounting measures Agrawal et al (1999) observed a negative relationship between board independence and firm's performance. Jeffrey et al (1990) found no evidence in favor of outside directors to enhance the firm performance.

For a better performance of a corporation it is necessary to monitor the operations of the firm regularly, it can be done by increasing the board meetings in a given year. The frequency of board meeting is an important dimension of board operations (Nikos Vafeas, 1999). He found the annual number of board meetings is inversely related to firm value. When independent from management, the Chairman can play a pivotal role in giving directors (particularly non-executive directors) a strong voice in setting agendas of Board meetings, deciding on executive compensation and encouraging meaningful discussions in Board meetings

Sanda et al., (2005) and David et al (1996) found a positive relationship between small-sized boards and corporate performance. Board size is found to be a positively correlated with firm value in between-firms tests, and changes in board size are found to be positively associated with annual stock returns (Y.T. Mak and Yuanto Kusnadi, 2005). Small board of directors is more effective (David yermack, 1996). Holthausen and Larcker (1993 b) fail to find consistence evidence of an association between board size and company performance.

Jiang (2004) explored that an Ownership structure and firm performance can be positive or negative relationship depending upon the sectors and time period. Jensen et al (2004) specifically identified that "the fraction of the equity held by the manager" as a fundamental to ownership structure. This same rationale has been applied to board members as well (Dan R. Dalton et al., 2003). Officers and directors, in various combinations, constitute inside equity holders (Bethel et al 1993). Corporate governance mechanisms can be divided into internal and external control mechanisms (Walsh et al 1990). Dong-Sung et al (2007) concluded that it is not important in case of Korean firms that who is CEO , but it is matter a lot that who the large shareholders. As large is the shareholder ownership it influences more on corporate performance. But in case of managerial ownership, it does not make any impact on firm performance. Inside equity holders are mainly CEOs, officers, or directors, Demsetz (1983) and Fama et al (1983) suggested that there is a positive relationship between an inside ownership and corporate performance. Dan (2003) results illustrated relatively low relationships between various categories of equity concentration and multiple indicators of financial performance.

Roberto et al (2005) concluded that family control hampers firm performance. Family control is positively correlated with firm value and operating performance in Continental European firms. Shahid Raza et al (2004) concluded that the family control have positive effect on firm performance. Miller et al (2007) confirmed the difficulty of attributing superior performance to a particular governance variable. Older firms are generally family-controlled, dispelling the notion that ownership becomes dispersed over time. The positive abnormal returns are greater for family controlled firms (Walid et al, 2006). Significant corporate wealth in East Asia is concentrated among a few families (Stijn et al, 2000). Pakistani market is also characterized with the concept of dominance of family business where they developed as group and their performance is distinguish from the firms which are not under any group as observed in Japan.(Nishat et al,2004)

Analytical Review

Over the past two decades, financial sector in Pakistan had undergone a phenomenon changes. The transformation is taken place by introducing financial reforms in this country. These financial reforms play a significant role in the growth of this sector. Privatization, restructuring of state owned banks, merger and acquisitions of private and foreign banks and introduction of Islamic banks have changed the governance structure of banking sector substantially. Before these reforms, financial sector in Pakistan mainly considered as a government sector. More than 90% market share was owned by state owned banks. These banks served as a tool to implement the government development strategy. In 1972, all commercial banks had been nationalized expect few foreign banks. These foreign banks could not expand their operations due to strong regulations. These banks were used to give credit to the preferred sectors of the economy and also loans were given on the political basis. Initially, the arrangement gave good results but it didn't sustain longer. The inefficiency of the banking sector observed shortly due to bad and influential governance by the government authorities. The proportion of non-performing loans were increasing day by day which results in high default rates of state owned banks.

The situation was realized shortly and new financial reforms introduced by State Bank of Pakistan in early 1990. The objective of these reforms was to strengthen the financial institutions by adopting the liberalization policy in prudential regulations. The primary justification to introduce these reforms has been the potential to eliminate systematic sources of inefficiencies in the banking sector. Not only the inefficiencies but also to improve the governance structure of this sector.

In First part of these liberalizations and reforms, ten new private banks were permitted to start their operation in early 1990's. Apart from domestic private banks, three foreign banks were also permitted to start their operation in the same period. As a part of these reforms, the control on opening new bank branches by private and foreign banks was also lifted. At the same time, privatization of state owned banks also took place by selling 26% shares of Muslim Commercial Banks to the private sector, 50% to the general public and remaining 24% also sold in 2001-02. Similarly, the privatization of ABL, UBL and HBL were also taken place. Mass privatization of state owned banks led to their market share down to 20% in 2005 as compared to 70% in 1990.

Secondly, state owned banks had also undergone through huge structural changes and downsizing. A fund was provided by the World Bank to state owned bank for their restructuring and downsizing in 1997. A large number of employees were voluntarily resigned from the banks under the golden shake hand scheme. Also, number of branches of state owned banks which were not performing well was also closed down.

Finally, the governance of banking sector in Pakistan was influenced by merger and acquisitions of some private and foreign banks. New policy introduced by State Bank of Pakistan has also encouraged merger and acquisition of small and struggling private and foreign banks by their financially superior counterparts. As a result, in a period of five years from 2000-2005, 12 banks are merged and acquired out of which nine foreign banks are acquired by the domestic private banks.

During this period, Islamic banking are also introduced by private and foreign banks in Pakistan. Initially, few Islamic banks are operated with a very little market share. But in very short period of time Islamic banking assets reaches to 411 billion with a massive growth rate of 6.1%. The investors are willing to invest in Islamic Banks rather than the conventional banks due to its strong governance structure. Pakistan has adopted an unusual three-tier *Shari'a-compliance* structure to ensure "deep and extensive" supervision of *Shari'a compliance*. The structure consists of the following components; (1) internal *Shari'a* advisers for Islamic banks, (2) a national *Shari'a-complaince* inspection unit, and (3) a national *Shari'a* advisory board established by the State Bank of Pakistan, the central bank (Akhtar 2006).

The banking sector in Pakistan enjoyed healthy returns and achieved high growth after making necessary adjustment in their corporate governance structure. More liberal but concerned governance structure is established in this sector. No more political influence, corruption and unnecessary control of government are there. This strong corporate governance structure protects the right of shareholder's which enhances the confidence of external investor.

Conclusion

When an investor feels himself more secure, he will invest more. For making the firm more profitable, one should protect the rights of the investor. This can only be happen if the firm has strong corporate governance structure. In this case, banking sector in Pakistan was influenced by the government authorities with weak governance which results in a low performing sector, but after making the necessary changes in the governance structure the very sector evident a phenomenon growth and high returns in it. We believe there are still some gaps left in the governance structure of the banking sector in Pakistan, but these gaps will fill up by the Islamic Banks due to their more reliable governance structure.

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