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How Corporate Governance Affect Bank Profitability? Evidence from Palestine

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Abstract

This study aimed to find out the impact of corporate governance on bank's profitability and how major Palestinian commercial banks performed their corporate governance concepts and practices from 2012 till 2017. Multiple regression models were used to do the empirical analysis and; develop two econometric models each model consisted of one dependent variable and four independent variables. In the first model Return On Assets(ROA) was defined as profitability indicator and Return On Equity (ROE) in the second model, while four aspects of corporate governance namely; board size (BS), the Directors' Ownership of Equity (DEQUITY), the leadership structure (CEO duality (CEOD) and the Director's educational degree (BDEG) used as independent variables. The findings and analysis revealed that the smaller board size , the more the combined leadership structure and the higher the Director's educational degree lead to better ROA , while results show insignificant relationship between directors' ownership of equity and ROA. Also the results revealed that the more the combined leadership structure, the lower directors' ownership of equity the more ROE, board size and Director's educational degree have insignificant effect on ROE.

Keywords: Corporate Governance, Banking Sector, Banking Profitability.

1. Introduction

There has been an increasing awareness of the corporate governance and it is mechanism in both the developed and developing countries. The scandals and the financial crisis in 2008, made the governments and international organizations to be more aware and to set a fundamental regulations and policies for companies to guide and promote the management of corporations practices, hence retrieve the public confidence in corporate governance, while Corporate governance of banking sector seems to be more important than other sectors because the banking sector plays a critical financial intermediary role in any economy. Corporate governance promotes risk management, and enhanced bank discipline and improve banks safety, while Poor corporate governance of the banks can cause loss of public confidence of a bank in the way to manage its assets and liabilities, including deposits However, corporate governance cannot substitute for strong supervision, but the good governance can provide a corporation with how to manage it is practices.

Corporate governance definitions are varied and take many forms that ranging from the simple definitions that focus on relation and accountability between firms and shareholders, to comprehensive definitions that integrate the accountability of other parties, or 'stakeholders', the concept of Corporate governance is very important to companies because it relates the different aspects of the company and enable it to meet and achieve it is objectives. It improves the company's' sustainability in business and facilitate the detection of opportunities. The most important effect of corporate governance is to build and increase the public confidence of the economy in general. Therefore corporate governance is all about accountability of company's practices and enhancing transparency by improving the information disclosure that would foster the performance of companies. (Solomon and Solomon, 2004).

Since the role of banks is crucial to accomplish the financial stability system in any region, it's important to focus more on governance mechanism used by banks, especially in Palestine and also in other countries (Monks and Minow 2008). Many studies show that the main problem which banks facing is the weakness of administration's commitment in adopting modern governance. Even though in Palestine they start given attention to corporate governance with making conference and workshops as a kind of promotion, but unlikely it seems that many obstacles keep appearing and stop this initiatives. Beside of the challenges, the Palestinian operating firms have no obvious legally framework, also no consistency in regulations, which detracted so much of initiatives that taken by regulatory bodies in the region (Awartani, 2005).

Therefore, it is important to examine the impact of corporate governance mechanisms in the banking sector. Many studies on corporate governance have tried to examine its impact on the financial performance of banking profitability (Rebeiz and Salameh, 2006; Fosberg and Nelson, 1999), the study focus is on the effect of governance on banking profitability, As there are many empirical studies which found that corporate governance, has an impact on bank profitability, however there are studies that did not capture the impact of governance on profitability (Laeven, 2009).

It could be summarized that the governance seems to be very important to the corporation, especially in the banking sector and it is a way to look at the bank performance from profitability aspect. Hence, the study aims to examine the effect of corporate governance on banks profitability, in order to pinpoint the importance of corporate governance in the banking sector of Palestine (Bhagat and Bolton, 2008).

The presentation of this study is as follows, first the introduction section highlight the problem statement and motivation of the study, then, discussion on corporate governance mechanism and profitability will be discussed in the literature review section. The research methodology is then .Finally, the research findings and recommendations for future study.

2. Previous Research

Corporate governance is a group of mechanisms that stakeholders use to guarantee that directors effectively manage corporate resources and one of the important controls in managing the firms operations; it is a general belief that good corporate governance enhances bank profitability. However, there have been some previous studies by western researches (Miller & Breton, 2006), and local studies (Ahmad, 2010; **Awwad,** 2014), that found mixed findings some are against this notion. For this reason it is inconclusive or inconsistent to say that corporate governance and bank profitability are directly correlated.

2.1 Board Size

Board size refers to the number of members of the Board of Directors, where the Board of Directors is responsible for overseeing the management of the Bank and ensures the interests of all relevant parties, especially the shareholders. Therefore, the Board of Directors represents the first line of defense of corporate governance tools to maintain and optimize shareholder wealth. Accordingly, the Board of Directors is an important role in establishing the rules of good governance by taking into account, the optimal number of members to ensure the best performance of the functions of the Bank (Miller& Breton, 2006)

Some studies show that the higher the number of members of the Board of Directors ,the superior the bank, due to the greater number of members responsible for rising capabilities and resources, expertise and relationships (Zuaini, 2005), where capacity is improved to solve problems, and there are many strategies to solve important decisions to amend the errors in the work.

In contrast, some studies show that the small bank's board of directors, the higher performance it is than its counterparts (Miller& Breton, 2006) where the small the number of directors the effectively and the quick the decisions are.

2.2 The Leadership Structure

The board leadership structure remains to be one of the most topical and controversial corporate governance mechanisms, board structure may be unitary -single tier or dual-two tier, unitary board structure is the practice of combining the functions of the chief executive officer (CEO) and the chairman of the board, which known as CEO duality. (Zuaini, 2003).

Previous studies showed mixed results about the influences of CEO duality and bank performance. some studies shown a positive impact or negative one, according to economic conditions, other studies which shown a positive impact admitted that despite of CEO duality has improve profitability in banks, but it should be used with caution because it may have a negative impact of the profitability on a very large multinational banks (Mallin, 2007).

2.3 The Directors' Ownership of Equity

The ownership structure is very important in enhancing corporate governance. If directors own shares, the directors as the owners themselves are directly instructing and monitoring the management of the companies, and there are likely to be fewer conflict of interest problems as compared to the situation where the directors, who are not the owners, supervise the management of the company (Hamadi, 2002). Hence it is expected that the higher the percentage of directors ownership will lead to better performance of the Banks .Many studies are in line with the theoretical expectation (Cornett et al,2007;Patibandla, 2006) ,but other studies find evidence of a nonlinear relationship between insider ownership and performance. (McConnell & Servaes, 1990).

2.4 The Educational Degree of Directors

The directors assume an important task in modern corporations. The primary responsibility of the directors is to monitor the management on the shareholders' behalf. In addition, the board advises the management and has decision power. This power includes setting the firm's strategy and executive compensation, appointing the top management and nominating new directors. Since the board of directors is vested with the responsibility of ensuring that the shareholders' money is not wasted, shareholders ought to have a serious interest in ensuring that the board is staffed with well educated and experienced directors (Daily, C. M. & Dollinger)**.**

More recent studies examine the impact of board characteristics on bank profitability or behavior; yet, few studies investigate the real value of the educational degree of directors on the profitability of the banks (Huse and Johanssion, 2000). The question of educational effect needs to be addressed.

2.5 Bank Profitability

The existing literature on corporate governance practices has used accounting-based performance measures, such as return on equity (ROE) and return on assets (ROA), (Abdullah 2004; Bhagat & Black 2002; Daily & Dalton 1993). "Profitability, solvency and liquidity are important goals of banks, profitability is the most important one" (Babalola, 2012), and since that, financial system is based on profitable and adequate capitalized banks, so that's why the attention on profitability is highly considered as quality. Banks profitability is strongly affected by monetary policy decisions because banks are highly regulate institutions, the existence of government regulations specially in taxation makes managers seeks for the most profitable investments, bank income structure also affected by major mutations caused by globalization that make banks to diversify their services which led to increase income , profitability also affected by the investing in informational technology because of huge competition in banks.(Lupu, 2011).

The study will use the Return on assets and Return on Equity as profitability indicators where the ROA measures the net income generated per dollar of a bank's assets, and ROE which measures the net income generated per dollar of shareholders equity.

ROA= Net Income / Total Assets

ROE = Net Income / Total Shareholder’s Equity

2.6 Overview of Palestinian Banking System

The banking sector is one of the most important components of the Palestine Financial system and the most influential factor in financial stability in general, as it is the major funding channel for the private and public sector. Therefore, the changes witnessed by the banking sector have direct and indirect impact on the overall economic activity.

Sixteen banks operated in Palestine at the end of 2017 with a total of 319 branches and offices, 278 in the West Bank and 42 in the Gaza Strip. Seven banks are locally owned (seven of which are listed on the Palestine Exchange, four are commercial banks, the other three are Islamic banks.) .Nine foreign banks maintain. The banking sector employed 5,763 staff, 2,331 in local banks and 2,348 in foreign banks. The clients’ deposits are the main and the most important source of banks external funds in general. By 2017, the balance of these deposits amounted to 12 billion dollars.

Direct credit facilities are considered the most important in funds investment in the local economy, due to their broad impact on all sectors of the economy; they form the engine of growth, and are important in stimulating domestic demand. Hence, the Monetary Authority has made great efforts to raise the volume of credit facilities, while reducing overseas balances, in a move to steer the Palestinian banking sector to serve the local economy. The positive effects of this plan continued during the year 2017, as the total value of direct facilities increased to $7900 million (Palestinian Monetary Authority, 2017).

Banking stability is not expected to be exposed to high risks arising from local non-payment by the private sector, especially in light of the significant improvement witnessed in the ratio of nonperforming facilities to total facilities; the rate has reached 3% by the end of year 2017, which is very low. This is due to improving the efficiency of supervision and banking infrastructure in the past years, as a result of the introduction of many electronic banking systems - especially the systems of credit information - that contributed to improving the efficiency of decisions to grant credit. The remaining risks are delays in payment by the public sector institutions, resulting from the reduction or delay of foreign aid to the Palestinian Authority. Such aid continues to represent a significant percentage to cover the budget deficit. However, the vast improvements in public financial management, and the policy of austerity cost control served to reduce these risks.

3. Hypothesis

Based on the literature review, the following hypotheses have been derived from the research questions:

H1a: Board size has a significant effect of on ROE.

H1b: Board size has a significant effect of on ROA.

H2a: leadership structure has a significant effect on ROE

H2b: leadership structure has a significant effect on ROA

H3a: Directors' Ownership of Equity has a significant effect on ROE.

H3b: Directors' Ownership of Equity has a significant effect on ROA.
H4a: Directors' Educational Degree has a significant effect on ROE.
H4b: Directors' Educational Degree has a significant effect on ROA.

4. Research Method

4.1 Sample

Palestinian commercial banks has been chosen for conducting this study in view of the effective role played by this sector in the saving investment process by channelling the savings and surplus funds of individuals and corporations into deficit units who invest these funds. There are only seven listed banks, and the two Islamic Banks are excluded.

Table 1: Selected data for the sample banks for the year 2011 in USD millions

No	Bank	Total Assets	Total Equity	Customer Deposits	Net Loans	Net Profit
1	Bank of Palestine(P.L.C)	4884	449	3768	2518	54
2	Al-Quds Bank	1075	102	855	658	11
4	Palestine Investment Bank	443	91	297	310	2
5	National Bank	1079	97	808	653	4

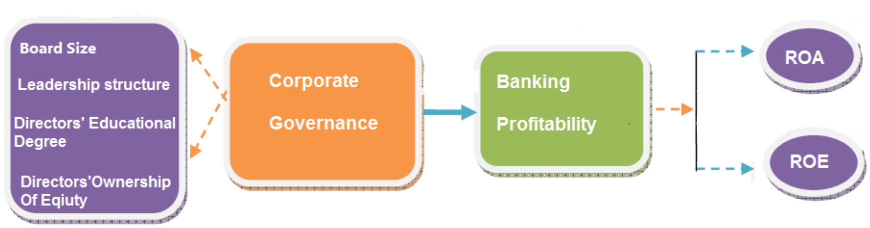
4.2 Source of Data

The primary data used for the study were from Annual Reports from 2012 until 2017.The study necessitates looking into corporate governance, financial statements and notes to financial statements in the annual reports of the sample banks. In Palestine, banks must submit their annual reports to the Palestinian monetary authority, so it's easy to get all annual reports of selected banks from the Palestinian Monetary Authority and from the web.

4.3 Applied Regression Model

In the light of the elements and the dimensions of the problem, the researcher built two study models on the basis of the relationship between the independent variables (expressed in terms of Board Size, the Directors' Ownership of Equity, Duality and the Director's educational degree on the one hand and the dependent variable (Bank's Profitability) on the other hand (see Figure 3.1). Based on that, the researcher used multiple regression models with one dependent and four independent variables in this study.

Figure1: Study Model



4.4 Mode of Analysis

In the present study, we analyze our data by employing descriptive analysis and multiple regressions. The following two models are formulated to for Social Sciences' (SPSS) was used in order to analyze the data. The following two models are formulated to measure the impact of corporate governance on banking profitability.

ROA = β0 + β1 BS +β2 DUAL +β3 BDEG +β4 BEO + eit (Model1)
ROE = β0 + β1 BS +β2 DUAL +β3 BDEG +β4 BEO + eit (Model2)
Where, β0, β1, β2, β3, β4, are the regression co-efficient;
ROE = Return on Equity
ROA = Return on Assets
BS = Board Size
CEOD = Duality (separate = 1, duality = 0).
BDEG = % of directors educational degree
DEQUITY = % of directors' ownership of equity
eit =the disturbance of error term

4.5 Model Specification

For corporate governance variables Board Size (H1a and H1b), and a dummy variable were used to measure CEO duality (H2a and H2b), Director's Educational degree (H3a and H3b), Director's equity ownership (H4a and H4b) .The Dependent variable (the Bank' profitability); the control variables in this study were size of the bank represented by it is total assets.

Variable	Measures
Dependent Variable	
Bank Profitability	Measured by: i. Return On Assets (ROA). ii. Return On Equity (ROE).
Independent Variables	
Board size	Measured by the number of the members
Duality of the CEO Leadership Structure	Takes two variables: i. 1- if the CEO is the chairman ii. 0- if not.
Directors' educational degree	Measured by directors with educational degree
Diretors' Equity Ownership	Measured by the percentage of equity owned by directors
control variable	
Bank Size	Measured by the total assets of the bank

5. Data Analysis and Testing the Hypothesis

One of the functions of multiple linear regression that examines the strength of the relationship between independent variables and dependent variable, In addition to that it works on framing this relationship in a mathematical model used for prediction .(Gujarati, 2003).

5.1 Descriptive Statistics

Table 2: Descriptive Statistics for regression variable

variable	Total Sample (N =5)			
	Mean	**Std**	**Min**	**Max**
ROA	1.55	1.9	0.03	7.8
ROE	7.39	5.7	0.2	18.8
BSize	10.4	1.3	8	13
CEOD	0.48	0.5	0	1
BDEG	32.35	8.9	18.18	45.45
DEquity	44.4	19.1	10	64

Table 2 showed the descriptive statistics of the variables used in the study. In case of board size, it had a mean value of (10.4), shows existence of quite a large board size. Jensen and Ruback

(2008) suggest that a board size of not more than 7 or 8 members is considered reasonable in ensuring effectiveness., the mean value of the board leadership structure (0.48) shows that nearly half of the banks does have separate leadership structure although the minimum value (zero) shows that there are companies which have combined leadership structure. The directors' educational degree mean value (32.35) means that only 32% of directors have a high educational degree mean that banks should be encouraged to search for directors who possess qualifications. For Directors' ownership equity, the mean values of director ownership are 44.4. The ownership of shares by directors can be considered high. The mean values of dependent variables are: for return on assets (1.55) and return on equity (7.39).

4.2 Regression Results

The multiple regression results of the study are presented in table 3 and table 4 for model 1 and 2 respectively.

Table 3: Regression results for model 1

ANOVAa

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	49.038	4	12.260	5.977	.002[b]
	Residual	41.020	20	2.051		
	Total	**90.058**	**24**			

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.738[a]	.545	.453	1.43212	1.337

Coefficient

Variable	Coefficient	Std. Error	t-statistics	Prop
BSize	-.981	.279	-3.517	.002
CEOD	2.907	.774	3.755	.001
BDEG	-.139	.050	-2.785	.011
DEquity	.042	.021	2.031	.056

The regression output in Table 3 is run by taking ROA as a dependent variable and other governance and control variables as regressors. The regression output reveals that the dependent variable is explained by the explanatory variables in the model with R-square and adjusted R-square of 0.54 and 0.45 respectively, that there is a weak explanatory power of the regressors in the model. The F- statistic is significant at 0.002 P-value, suggesting that variations in the dependent variable are adequately explained by the regressors in the model.

The coefficient table, showed that the variables BSize, CEO duality, have positive significant relationship with ROA, while BDEG has significant negative relationship with ROA. This indicate that the Board Size, leader ship structure (CEO duality) and educational degree of directories(BDEG) are statistically significant at 1%, therefore, the hypothesis number 1, 2 and 4 is accepted, in which it indicates that there are statistically significant effect of board size, CEO duality and directors' educational degree on ROA. On the other hand, directories ownership of equity doesn’t have a statistically significant effect on banking performance, as measured by ROA; therefore, hypothesis number 3 will be rejected. The table shows also that there is an adverse effect on performance appeared in board size, suggesting that banks with larger boards tend to perform poorly compared to banks with smaller boards.

Table 4: Regression results for model 2

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	603.923	4	150.981	16.766	.000[b]
	Residual	180.099	20	9.005		
	Total	**784.022**	**24**			

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.878[a]	.770	.724	3.00082	2.245

Coefficient

	Variable	Coefficient	Std. Error	t-statistics	Prob
	BSize	.703	.584	1.203	.243
	CEOD	3.598	1.622	2.218	.038
	BDEG	.199	.104	-1.905	.071
	DEquity	-.169	.044	-3.859	.001

Table 4 showed that the adjusted R^2 for the regression model is 0.724, indicating the regrossers in model 2 can explain 72.4% of the variation in the dependent variable ROE. The F-statistic for the regression is also significant at 0.00001 P-value. This shows that there is a good explanatory power of the regressors in the model.

The coefficient table showed that the variables CEO duality and directors' ownership of equity are significant. These indicate that the CEO duality statistically significant at 5% and directories ownership of equity statistically significant at 1%, therefore, hypothesis number 2 and 3 are accepted. On the other hand board size (B size) and educational degree of directories (BDEG) don't have statistically significant effect on banking performance, measured by ROE, therefore, hypothesis number 1 and 4 are rejected. The table shows also that there is an adverse effect on performance appeared in directories ownership of equity, suggesting that banks with larger directories ownership of equity tend to perform poorly compared to banks with smaller directories ownership of equity.

5. Summary and Concluding Remarks

The appliance of corporate governance principles for banks in Palestine was measured based on variables related to the board, and variables related to the ownership concentration within the sampled banks. Results of the study illustrate that the variables Board Size, CEO duality, Board educational degree are significant. This indicate that the Board Size, CEO duality and educational degree of directories are statistically significant, on the other hand, directories ownership of equity don't have a statistically significant effect on banking performance, as measured by ROA and there is an adverse effect on performance appeared in board size, suggesting that banks with larger boards tend to perform poorly compared to banks with smaller boards. Also the results showed that the variables CEO duality and directors' ownership of equity are significant with bank's profitability, as measured by ROE. This indicate that the CEO duality statistically significant at 5% and directories ownership of equity statistically significant at 1%, on the other hand board size and educational degree of directories don't have statistically significant effect on banking performance. Also there is an adverse effect on performance appeared in directories ownership of equity, suggesting that banks with larger directories ownership of equity tend to perform poorly compared to banks with smaller directories ownership of equity.

Corporate governance philosophies vary all over the world. However, with a few relatively minor exceptions, there is a broad consensus on the elements of good corporate governance. According to the understanding of the importance of the existence of effective corporate governance mechanism in monitoring banks values, much progress and actions have to take place in Palestine to enhance the protection of banks' shareholders and stakeholders' interests. Another challenging issue could be of an interest for investors, is to investigate the effect of sound corporate governance on specific financial performance indicators such as EPS, which has not been identified so far but would be fundamental to assess different investment decisions.

The study is based on a simplistic model of corporate governance that has taken into account only four aspects, namely, Board Size, Board Educational Degree, CEO duality and Directors' ownership of equity. There are other factors that also may affect the profitability of banks. A further study can be conducted to include more factors in the models and an expansion in the scope of the study by examining other industries may be carried out for better understanding and generalizing of the findings.

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