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Effect of Corporate Governance on Banking Performance: Evidence from Vietnam

[1] Huy Hoang Tran, [2] Hong Anh Thi Nguyen, [3] Quang Linh Huynh
[1] University of Finance-Marketing, [2] Industrial University of Ho Chi Minh City, [3] Tra Vinh University, Vietnam
[1] hoangth@ufm.edu.vn, [2] honganhtugi@gmail.com, [3] quanglinhhuynh@gmail.com

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Abstract:

This research investigated the causal relationship between corporate governance and banking performance of banks in Vietnam. The research tried to review and establish the hypotheses on the influence of corporate governance dimensions on banking performance. The research sample of the study consists of 78 usable firm-year observations selected from 25 publicly listed banks in Vietnam over a 4-year period from 2015 to 2018. The three mechanisms of corporate governance were chosen for research analyses, which are the duality of the chief executive officer and chairman, the percentage of independent executives in the managerial board and the size of the managerial board. Banking performance is measured based on ROA. The empirical results show statistical evidence on the causal links from corporate governance to banking performance, where the duality of the chief executive officer and chairman negatively affects banking performance, the percentage of independent executives in the managerial board positively influences banking performance and the size of the managerial board positively affects banking performance. The empirical findings are useful to banking executives in their business decisions on the choice of suitable mechanisms of corporate governance that can help to develop and maintain competitive advantages for banks that therefore achieve the best possible banking performance.

Keywords: *Banking performance, banking sector, corporate governance, Vietnam*

I. INTRODUCTION

Recent research on corporate governance has remarkably increased due to its importance to organizational success (Abobakr, 2017). Corporate governance is critical as a result of the separation of ownership and management in publicly listed firms (Fanta et al., 2013). Within organizations, shareholders (principals) delegate the rights to managers (agents) to make business decisions, requiring the agents to act in the greatest benefits for the principals. However, the "agency problem" occurs when the agents do not make their decision to the greatest benefits of the principal, but tend to be engaged in self-interest at the costs of shareholders. Wheelen et al (2010) regarded corporate governance as the bond among shareholders, managerial boards and the top director in determining the way and effectiveness of the organization. Furthermore, corporate governance is also referred to as the arrangements, processes, procedures and mechanisms, which are applied to direct and control firms in a way to improve long term benefits for shareholders through the accountability of directors and so boost organizational performance (Tomar & Bino, 2012). With such the arrangements, processes, procedures and mechanisms, the recognized agency problem, derived from the difference between ownership from administration leading to the conflicts of benefits among stakeholders, could be addressed such that the interests of directors with those of shareholders can be aligned. The previous studies have discussed a lot on the link between corporate governance and firm performance; but, only a little empirical research analyzed corporate governance in the banking sector (Muttakin & Ullah, 2012).

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The 2007-2008 monetary crises have again leaded to the disputes on the link between corporate governance and banking performance (Naushad & Malik, 2015). In spite of its significance, this topic has been examined by only a little research. Several research projects have discussed banking governance; nonetheless, most of them focused on non-financial organizations excluding banks and other financial firms. Besides, these projects were mostly performed in developed economies. Recently, just some attention to corporate governance in emerging economies has been paid (Abobakr & Elgiziry, 2017). In developing economies, corporate governance faces various challenges such as low institutional ownership, centered ownership and underdeveloped finance markets (Latif et al., 2017); there is therefore a big need to carry out research on this field in those countries including Vietnam. Furthermore, very little has been considered for the banking sector, especially for Vietnam's banking sector. The banking sector in Vietnam has made considerable developments deriving from stable inflation and interest rate, favorable environment for foreign direct investment and transformation from deficit to surplus of the nation's current account. Vietnam's banking sector has played a critical role in developing the national economy. In Vietnam, there exist two levels in the banking sector. Firstly, the State bank of Vietnam is responsible for monetary policy and supervision/regulation of the banking system in Vietnam. Secondly are commercial banks, financial companies, credit co-operatives, people's credit funds, and insurance organizations.

This study is targeted to examine the causal link from corporate governance to banking performance in Vietnam as an emerging economy. The current study is expected to make some contribution to the contemporary knowledge of corporate governance that explains banking performance. This research is continuing in the following structure. 'Literature reviews and hypotheses' make the arguments to support the important role where corporate governance plays in improving banking performance. Afterwards, the 'Research design' offers the guidance for measuring the variables and collecting the data, followed by the 'Empirical findings'. Ultimately, some discussions and conclusions will be made in the 'Discussions and conclusions'.

II. LITERATURE REVIEW AND HYPOTHESES

The sector of banking has made important contributions to the growth of every economy. Given that banks play the unique role in the payment system and financial intermediation, the collapse of them is able to destroy the economy such as the 2007-2008 global financial crises (Owino & Kivoi 2016). A lot of policymakers deem that the efficiency of banks can augment the competence of monitoring and ensure a sound financial system, which helps economic growth; yet, employing the mechanism of corporate governance to improve banking effectiveness has been still addressing considerable challenges because of the distinctive nature of the banking sector. The structure of corporate governance in the banking industry has supposed sharp importance and has raised international concerns as it helps to improve the quality of services, leading to appropriate management in the activities of banking (Fidanoski et al., 2014). The intricate nature of banking may result in asymmetric routing that limits shareholders' monitoring the self-interest behaviors of banking managers (Jiang et al., 2012). Good mechanisms of corporate governance likely allow banks to alleviate the conflicts of interests among stakeholders, which play a critical role in lessening agency costs due to the separation between ownership and management as well as the majority of independent managers in the managerial board, so improving hence create competitive advantages for the banks. This will lead to sustainable economic development and banking performance for the banks. Different theories related to corporate governance have been developed on the nature and importance of corporate governance such as agency theory, stewardship theory, and stakeholder theory (Fanta et al., 2013).

Agency theory is commonly regarded a tool of clearing up a variety of issues relevant to corporate governance, called the principal-agent theory. The principal-agent theory is commonly regarded as a starting point for any arguments related to corporate governance originating from the conventional view. The primary issue of agency in contemporary companies is mainly because of the separation between management and ownership. The contemporary companies are deemed to suffer from that separation. As a result, they are administrated by

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qualified directors who are not able to be monitored by separate shareholders. Agency theory recommends numerous mechanisms to lessen the agency problem within the organization. Encouraging mechanisms can be used to compensate managerial efforts of serving the principals' benefits. Dividend mechanisms diminish managerial intention to make overinvestment decisions that can be funded by internal free cash flows. Bonding mechanisms decrease managerial ethical risk that likely occurs when they can be not constrained by bond contract and bankruptcy risk (Sanda et al., 2005).

Stewardship theory anchored in sociology and psychology highlights that directors are not motivated by separate objectives but rather they are stewards, whose motivation is aligned with those of their owners (Davis et al., 2005), in contrast with agency theory asserting that the conflict of benefits between agents and principals is inevitable unless suitable mechanisms of management are applied to align these interests. The stewardship viewpoint proposes that stewards (directors) can be satisfied and motivated when firm effectiveness is achieved even at the cost of the stewards' individual objectives (Abdullah & Valentine, 2009). From the view of stewardship theory, directors behave in a manner to seek other values in their jobs such as a good reputation, rather than trying to improve their own worth. Stewards find their strong duties and commitment to their organizations. Therefore, when the firm's objective is achieved, the benefits of stewards are maximized.

Stakeholder theory has been more well-known as various studies have documented, firms' behaviors influence organizational external environment requiring accountability of the firm to wider stakeholders than simply its shareholders. McDonald and Puxty (1979) stated that, firms are not any longer the tool of shareholders alone but exist within society. Hence, they are supposed to be responsible to the whole society. It has been recognized that economic value is produced by those who willingly come to work together to advance everyone's situation (Freeman et al., 2004). An extension of the stakeholder theory as a progressive one was suggested; but problems concerning the empirical test of the extension have restricted its importance (Sanda et al., 2005). The goal of a firm not only earns money to satisfy its investors and management, but also invariably learn suitable methods to balance the interests among its various stakeholders in order to ensure that every constituency will attain some certain degree of satisfaction for their benefits (Abrams, 1951).

Prior research stressed that, the positions of the chief executive officer and chairman should be separated by two individuals (Kang & Zardkoohi, 2005). Duality is cleared as the appointment of the same individual over the same period for the two positions of the chief executive officer and chairman. As regards the banking industry, little research has analyzed the influence of duality on banking performance. Pi and Timme (1993) discover that the effectiveness of banking is lower due to the duality of the chief executive officer and chairman. Really, a combined role of the chairman and chief executive officer takes into consideration the better knowledge of the activities and the bank's environment. The duality can enhance the capability and commitment of management to their banks, so lead to higher banking effectiveness. They are motivated to develop a good reputation in the labor market. The duality has significant costs that offset its potential benefits for most large firms. Indeed, the position of the president of banks is extremely valuable to pursue a strategy of rooting and to enjoy its rights.

Agency theory recommends that a greater percentage of independent managers can improve banking performance because it can lessen the conflict of interests between the principals and agents that makes administration more effective with better monitoring (Shleifer & Vishny, 1997). Prior research discovers that the independence of boards is positively related to banking performance (De Andres and Vallelado, 2008). The role of managerial boards is largely dependent on the characteristics of these boards, which can influence banking performance (Johnson et al., 1996). Agency theory suggests that a greater percentage of independent executives will augment the supervision and minimize any self-interested behavior by directors; so can lead to improved banking performance.

A significant association between board size and firm performance has been found in previous studies. Lipton and Lorsch (1992) assert that a bigger board may face poor coordination due to a large number of

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potential interactions among group members. However, other researchers have revealed a positive relationship between board size and banking performance (Adam & Mehran, 2012; Dalton & Dalton, 2005). It is argued that larger boards may enhance performance because they have valuable business experience, expertise, skill and social and professional networks which might add substantial resources (Setia-Atmaja et al., 2009). Therefore, it is true that the size of the board is an important factor in dealing with corporate decisions and banking performance. Additionally, by examining the relationship between the size of the board and performance, Belkhir (2005) found, in contrast to theories that predict that smaller boards are more efficient. Instead, this scholar found a positive relationship between the size of the board and bank performance. Overall, the aforementioned arguments can come to the following hypotheses.

H1: The duality of the chief executive officer and chairman negatively affects banking performance

H2: The percentage of independent executives in the managerial board positively influences banking performance

H3: The size of the managerial board positively affects banking performance

III. RESEARCH DESIGN

Corporate Governance (CE) is measured with the duality of the chief executive officer and chairman (CE1), the percentage of independent executives in the managerial board (CE2) and the size of the managerial board (CE3). CE1 is considered 1, where the chief executive officer and chairman is the same person, otherwise = 0. CE2 is calculated by dividing the number of independent executives by the total amount of members in the managerial board. CE3 is measured by summing up the total amount of members in the managerial board. These measurements are adapted from Wang and Huynh (2014) and Naushad and Malik (2015). Banking performance is measured with the value of ROA (BE), which is get after dividing the operating income by the total assets for each bank. This measurement is adapted from Naushad and Malik (2015).

The research population of this project consisted of publicly listed banks on the three main Stock Exchanges in Vietnam, which were totally 25 banks. Before collecting the data for the research analyses, a pilot test was performed for measurements with 20 directors involved in management to ensure that the measurements in the research model are valid and suitable (Blair & Conrad, 2011). The sample size covered a 4-year period from 2015 to 2018. With the 25 banks, there were 85 suitable firm-year cases and only 78 usable firm-year observations. This number of observations satisfies the lowest limit of the research sample size suggested by Nunnally (1978). Vietnam was selected as a case study for the current study as it has been one of the fastest developing nations and a member of Southeast Asia. Additionally, as the third most populous Southeast Asian nation after the Philippines and Indonesia, Vietnam hopes to make gradually more great contributions to the world. The active and fast changing business environment leads banks in Vietnam to pay more attention to efficient managerial mechanisms to maintain and develop sustainably.

IV. EMPIRICAL FINDINGS

The problem of multicollinearity makes the linear regression estimates inexact, so it is necessary to be tested. Multicollinearity exists in multiple linear regressions when two or more of the independent variables in the research model are closely related. Table 1 shows the correlations among the three independent variables used in the research, namely CE1, CE2 and CE3. All of the correlations among these three variables are under 0.7, the greatest level stipulated by Nunnally (1978), indicating no multicollinearity occurs in the data.

Table 1: Correlations among independent variables

		CE3	CE2	CE1
CE3	Correlation	1	.254	-.077
	Sig.		.025	.503
	N	78	78	78
CE2	Correlation	.254*	1	-.067
	Sig.	.025		.560
	N	78	78	78
CE1	Correlation	-.077	-.067	1
	Sig.	.503	.560	
	N	78	78	78

In order to test out the three hypotheses that state that the duality of the chief executive officer and chairman, the percentage of independent executives

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in the managerial board and the size of the managerial board affects banking performance, this research carried out the multiple linear regressions. The empirical findings are shown in Table 2, indicating that the three (3) variables of corporate governance explain 39.1% of variation in banking performance with F of 15.843 at the 1% significance level.

Table 2: Multiple regressions

	BE		
	β	t	Sig. (t)
C_0	.585	1.393	.168
CE1	-.518	-2.330	.023
CE2	.391	4.579	.000
CE3	.017	2.984	.004
$R_{\text{-squared}}$	.391		
F	15.843		
Sig. (F)	.000		
Durbin-Watson	2.263		

The duality of the chief executive officer and chairman (CE1) negatively affects banking performance, where the β is -0.518 at the 5% significance level. The percentage of independent executives in the managerial board (CE2) positively influences banking performance with the β of 0.391 at the 1 % significance value; whereas the size of the managerial board (CGE3) positively influences banking performance with the β of 0.017 at the 1% significance level. Furthermore, the Durbin Watson statistic value is 2.263, falling between dU to (4-dU), demonstrating that there is no autocorrelation in the multiple regressions. Those findings are all in support of Hypotheses 1 to 3 where the duality of the chief executive officer and chairman, the percentage of independent executives in the managerial board as well as the size of the managerial board impose statistically significant influences on banking performance.

Overall, it can suggest that, the duality of the chief executive officer and chairman is the most imperative variable to banking performance at the -0.585 coefficient level; while the size of the managerial board plays the least important role in leading improved banking performance with the 0.017 coefficient. The percentage of independent executives in the managerial board takes the second most important role in improving banking performance with the 0.391 coefficient.

DISCUSSIONS AND CONCLUSIONS

Earlier studies have explored the causal link from corporate governance to organizational performance; however, to the best of my knowledge there has been only a little empirical research that analyzed on banks' corporate governance and its influence on banking performance (Muttakin & Ullah, 2012). Furthermore, these studies were carried out mainly in developed nations. Recently, there is some attention to corporate governance in emerging economies (Abobakr & Elgiziry, 2017) and very little has been considered for the banking sector, especially for Vietnam's banking sector. The current research seeks to examine the causal link from corporate governance to banking performance in Vietnam as a rising country. The empirical findings disclose that good mechanisms of corporate governance in a bank can lead to superior banking performance. The banks, where the positions of the chief executive officer and chairman are held by one individual, may suffer agency costs, so achieve poorer banking performance. Therefore, the banks in Vietnam should assign the positions of the chief executive officer and chairman to two separate individuals. The results also imply that, the banks should hire more independent executives in the managerial board in order to lessen agency costs, so can get better banking performance. Moreover, the banks with larger managerial boards can improve banking performance since they have more valuable business experience, expertise, skill and social and professional networks which might add substantial resources, so enhance banking success.

For the managerial knowledge, the current research provides statistical evidence that banks where the amount of independent executives in the managerial boards is dominant, the positions of chairman and chief executive officer are separately taken by two different individuals, and higher sizes of managerial boards likely obtain better banking performance. To banking executive officers, the current study sheds an insight on the causal linkage from corporate governance to banking performance in Vietnam as a developing nation, which helps them understand comprehensively this relationship. Those can lead the banking executives to make better business decisions on the choice of good corporate governance mechanisms to build competitive advantages in a

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dynamic and rapidly changing business environment in Vietnam, and consequently improve their banking performance.

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