NPL and Corporate Governance:
A Case of Banking Sector of Pakistan

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Abstract

This study examines the role of corporate governance on the non-performing loans of the banking sector of Pakistan. The study also examines how the government type either democratic government or dictator government influence the banking industry in nonperforming loans context. This study sample includes all types of banks i-e State owned banks, Private Banks and foreign private banks operating in the Pakistan. This research utilizes the secondary data for the time span of 1996 to 2007. Method of the analysis used for the data is Regression. The study reveals that corporate governance does matter significantly for the nonperforming loans of the banks generally. Specifically board size has positive effect on the non-performing loans while ownership concentration and board independence effect negatively. Furthermore the study explores that during dictator regimes non-performing loans decrease significantly.

Keywords: Board size, Ownership concentration, Board Independence and Non-performing Loans

1. Introduction

Banks plays a key role in the economic development of any country. Banks are very special deriver in the economic development of any country as they are providing the blood to the economy in the form of lending to deficit units. So this sector is markedly different from other sectors. The banking operations are quite complex and regulators are beset of variety of problems.

Starting from Atkinson and Stiglitz (1980), traditional economist views that public enterprises aid for the market failure. The rationale behind the state owned enterprises is that their core objective is to promote the social welfare. Public enterprises are more productive and efficient and charge prices accordingly to the marginal social cost. Milton Friedman (1962) did the rise voice against the state owned enterprises. But recent evidence on the failure of state owned enterprises is accumulated and advances in the ownership theories highlighted the importance of firm's ownership. It becomes clear that private ownership is source of innovation and efficiency. Samuelson (1948) called the "tremendous vitality" of the free enterprise system. Private ownership has strong support from the academicians and researchers around the world.

The public enterprises view is hardly foursquare with a strand body of empirical accounts of public firms in market and emerged economies. There are mixed views for such firms as state owned enterprises are highly inefficient and this is due to the political pressures from the politicians who controlled them. Donahue (1989] highlight point out that government agencies providing municipal services to employ 20 to 30 percent more people in the Unite state of America. The beneficiaries are the government supporters. In Greece all employees of the public firms turn over when position party took over the country.

Excess employment is not the only source of political benefits. State owned enterprises in many ways produce results desired by the politicians rather than the stakeholders. This could be illustrated by the Pakistani state owned banks that produced the huge amount of the nonperforming loans. Many state owned banks sanctioned loans to politicians without merit and resulted bulk of nonperforming loans. These nonperforming loans not only hurt the sector only banking sector but also the Pakistani economy. This is the reason why later in 1990's Pakistani government lunched the reforms and privatized many banks. Credit Lyonnais French central bank lost billions of dollars in loaning to the friends of the socialist party [The Economist, April 9, 1994].

Public theories challenge the idea of government ownership by making the argument that politicians and bureaucrats might use state owned institutions to secure their political career. This is very common in the developing countries where the institutional environment is weak and shareholders have less information and not able to monitor the enterprise performance. Public theory has been proven by studies see (World Bank, 1995; Li and Xu, 2004; Kikeri et al., 1992 and Jones, 1985). Shirley and Walsh (2000) point out three reasons why public enterprise perform less than private and privatized enterprises: Political intervention, corporate governance problems and issues related with the competition. Political intervention means that politicians and bureaucrats can use their powers to benefit their supporters and voters. Secondly in state owned enterprises there is a problem of weak corporate governance as compared to private enterprises.

Pakistani banking sector was dominated by state owned banks back in 1990's (e.g. out of 426 total banks 392 were state owned banks) Lack of good governance and politician's interference hurt the sector badly and banks generated huge non-performing loans. To overcome this critical situation Pakistani government lunches the banking reforms in 1990's. The core objectives of these reforms were to privatize the state owned banks to let make the industry more efficient and reduce the political intervention. This act empowered the federal government to sell full or part of share capital in national banks. Through this act governments not only sold the share capital of state owned banks but also welcomed the new banks to strengthen the competition in the market. As a result within two year 11 new banks entered in Pakistani banking industry.

To make baking industry more competitive, Pakistani government opened the doors for the international player as a result many foreigner banks entered in Pakistan. Foreign banks provide best customer services and incorporate the good governance that push other domestic private banks and state owned banks to practice them for their survival. Foreign banks entry makes the realization of good governance and best services to the domestic banks. So they return to Pakistan economy in monetary and non-monetary form e.g. from taxes to the good governance policies for the domestic sector.

The main objective of this study is to examine the role of corporate governance at nonperforming loans. How well governance in terms of board size, Board independence could help banks to minimize the non-performing loans. Furthermore we extend, is ownership does matter for the no performing loans. As governments do have direct control on the state owned firms including the banks, and indirectly all firms operating in the country. We see how government type influences of the nonperforming loans in the banking sector of Pakistan.

This study contributes in the existing literature in two ways first; there are so many studies that used impaired loans as the proxy for the performance but there are few studies that used its dependent variable and find its relation with the impaired loans. Secondly the few studies available they investigated it in whole banking industry not bank wise. So this study not only explores this relationship as a whole banking but also bank ownership wise like domestic private banks, foreign private banks and state owned banks.

The rest of the study consists as follows. Following section explains the literature review and next section discusses the data and methodology issues. Third section holds discussion on the empirical results of the data. Final section contains the conclusion along with the limitations.

2. Review of Literature

Recent financial crisis shifted the researchers and practitioners attention towards bank's corporate governance. The Basel Committee on Banking Supervision (BCBS) (2006) highlights that "effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole". To date most studies targets developed countries and comparably little known about the corporate governance and its role in banking industry of the developing economies. Board size is one of the key variables to determine the corporate governance. There are so many efforts have been done so far to find the optimal board size but still the results are mixed. It is very interesting debate among researchers in two ways Does board size really matter for the performance of the firms and what should be the board size.

Maria et.al (2009) explored the effect f board size and composition on the banking efficiency for 57 large European banks over the period of 2002-2006. They empirically concluded that higher the board size less the efficiency of the banks. They took non-performing loans ratio as the measure of the inefficacy. SimilarlySimpson and Gleason (1999); Belkhir (2006) and Altunbas, Gardener, Molyneux and Moore, (2001) came with the same conclusion that higher the board size lower the performance of the banking and high non-performingloans.A strand of literature revealed the importance of the board independence and concluded that higher the bard independence is higher the efficiency of the banks i.e. Raheja, (2005); Harris and Raviv, (2008) and Adams and Mehran, (2003). Fama (1980) and Fama and Jensen (1983) document that independent directors are more likely to protect the shareholders right to let realize the importance of outside directors on board. Bussoli (2015) explored the relationship between corporate governance and banks loans performance and empirically stated that board size negatively influence the quality of loans and resulted in higher nonperforming loans.The same argument is proved by y Farrell and Whidbee (2000). In the light of above discussion we make a hypothesis:

H1: Board size has positive influence on non-performing loans of the Pakistani banking industry

H1a: Board size has positive influence on non-performing loans of the Pakistani foreign Private banks

H1b: Board size has positive influence on non-performing loans of the Pakistani domestic Private banks

H1c: Board size has positive influence on non-performing loans of the Pakistani state owned banks

Although the empirically findings on the board independence and perform in mixed in the literature. For Instance Hermalin and Weisbach, (1991); Bhagat and Black, (1999); Kiel and Nicholson, (2003); Agrawal and Knoeber, (1996) find no relationship between the board independence and firms performance.Vuyst and Ooghe (2001) empirically proved that firms with the outside directors perform better. Moreover, Skully (2002) suggest more outside directors are good for the banking governance.

Hence we develop hypothesis

H2: Independent Directors have negative influence on non-performing loans of the Pakistani banking industry

H2a: Independent Directors have negative influence on non-performing loans of the Pakistani foreign Private banks

H2b: Independent Directors have negative influence on non-performing loans of the Pakistani domestic Private banks

H2c: Independent Directors have negative influence on non-performing loans of the Pakistani state owned banks

In the literature of the corporate governance ownership concentration s considered to be the important factor. It is widely used that higher the ownership concentration high the performance of the firm. In banking perspective higher concentration means higher check of the efficiency of the management if they management did not produce the desired outcomes, next time shareholder will not elect them again so in higher concentration they tried to perform well. A rich body of literature showed there is significant positive effect of higher concentration on the performance of the firms. Shleifer&Vishny, (1986) explained that higher ownership concentration is a good ingredient for the better governance. Boyd et al.,(1998) explains if the ownership is among the large funds supplier it will cause increase in the non-performing loans. Caprio et al., (2007); Azofra&Santamaria, (2011) empirically proved that there is direct and positive influence of the corporate governance and banking performance. The literature suggests us to make hypothesis

H3: Ownership concentration has negative influence on non-performing loans of the Pakistani banking industry

H3a: Ownership concentration has negative influence on non-performing loans of the Pakistani foreign Private banks

H3b: Ownership concentration has negative influence on non-performing loans of the Pakistani domestic Private banks

H3c: Ownership concentration has negative influence on non-performing loans of the Pakistani state owned banks

The culture and the regulations of the country does matter a lot for the performance of any business and banks have no exception. Normally regulations are formed by the governments so we cannot ignore the role of governments especially where state owned banks are dominated by the state owned banks. Before the reforms in 1980's Pakistan banking industry was dominated by the state owned banks and more interestingly Pakistan is democratic country but unfortunately there are many military cue over the short history 68 years.So it has been widely argued that state owned banks are inefficient. In Pakistan due to political interference banks produced a huge amount of nonperformingloans this is why later in 1980's government of Pakistan launched the reforms to get over this issue. Brown and Din ç (2005), Din ç 1 (2005) argued that politicians do have influence in the credit market of the banks and use it for their political purpose. In the same line Gomez and Jomo (1999) and Fraser et al. (2006) explained firms with the political connections are highly leveraged due to their connection with the politicians. Furthermore, Cornett et al. (2008) concluded that state owned banks are significantly less profitable than the private banks. Similarly Micco et al. (2007) also illustrated that state owned banks are underperform in developing countries but perform well in developed countries.

By studying existing literature we formulate our hypothesis as

H4: Democratic government has positive influence on non-performing loans of the Pakistani banking industry

H4a: Democratic government has positive influence on non-performing loans of the Pakistani foreign Private banks

H4b: Democratic government has positive influence on non-performing loans of the Pakistani domestic Private banks

H4c: Democratic government has positive influence on non-performing loans of the Pakistani state owned banks

3. Data and Methodology

The best determinants of the corporate governance are controversial among researchers. There is no consensus which variables are the best predictors of the governance. Different researchers use different variables, so it is little difficult what variables should we take to measure the corporate governance so by following the literature we choose Board Size (BS), Board Independence (BI) and Ownership Concentration (OC) as corporate governance variables, widely used in literature i.e. Jensen, (1993); Lipton and Lorsch, (1992); Klein, (2002) and Yermack, (1996).

Board independence is measured by the ratio of seventy percent directors are from outside by inspiring from the literature. We quoted board independent and not independent with 1 and o respectively e.g.Li Li et al.(2013) and Dahya et al. (2008).As government type is subjective term and measure its effect is a little bit difficult. We introduced this variable in a way that government type (either democratic type of government elected government or Dictator Type of government ruler by the cue) by assigning 1 as democratic government period and 0 as dictator government period. We collected corporate governance data from the published financial statements of the banks, while the data of non-performing loans has been taken from the central bank of Pakistan. The study covers the time period of 1996 to 2007. The main reason to select this period, during nineteen's Pakistani banking went through different reforms and its fruits came in this time period. We employ different statistical tools to measure the proposed relationship. Following models have been used

$$\ln NPL= \alpha+\beta_1 BS+\beta_2 BI+\beta_3 OC+\beta_4 \text{Government Form}+ \varepsilon \quad (1)$$

Where

NPL= Non-performing Loans

BS= Board Size

BI= Board Independence

OC= Ownership concentration

$$\ln NPL= \alpha+\beta_1 BS_{FPB}+\beta_2 BI_{FPB}+\beta_3 OC_{FPB}+\beta_4 \text{Government Form}+ \varepsilon \quad (2)$$

Where

NPL_{FPB}= Non-performing Loans of Foreign Private Banks

BS_{FPB}= Board Size of Foreign Private Banks

BI_{FPB}= Board Independence of Foreign Private Banks

OC_{FPB}= Ownership concentration of Foreign Private Banks

$$\ln NPL= \alpha+\beta_1 BS_{DPB}+\beta_2 BI_{DPB}+\beta_3 OC_{DPB}+\beta_4 \text{Government Form}+ \varepsilon \quad (3)$$

Where

NPL_{DPB}= Non-performing Loans of Domestic Private Banks

BS_{DPB}= Board Size of Domestic Private Banks

BI_{DPB}= Board Independence of Domestic Private Banks

OC_{DPB}= Ownership concentration of Domestic Private Banks

$$\ln NPL= \alpha+\beta_1 BS_{SB}+\beta_2 BI_{SB}+\beta_3 OC_{SB}+\beta_4 \text{Government Form}+ \mathcal{E} \quad (4)$$

Where

NPL_{SB}= Non-performing Loans of State owned Banks

BS_{SB}= Board Size of State owned Banks

BI_{SB}= Board Independence of State owned Banks

OC_{SB}= Ownership concentration of State owned Banks

4. Results and Discussion

Table 1. Bank wise Descriptive Statistics

Descriptive Statistics of Foreign Private Banks

Variables	Observations	Mean	Std. Dev	Min.	Max.
BS	123	7.32	1.95	5**	15**
BI	123	0.53	0.28	0	1
OC	123	0.31	0.67	0	1
NPL	123	830.95**	1998.21	.02	12772.25

**Important facts

Descriptive Statistics of Domestic Private Banks

Variables	Observations	Mean	Std. Dev	Min.	Max.
BS	147	8.69.	2.23	4**	16**
BI	147	0.35	0.39	0	1
OC	147	0.52	0.56	0	1
NPL	147	1521.23**	2203.07	0.32	13031.12

**Important facts

Descriptive Statistics of State-Owned Banks

Variables	Observations	Mean	Std. Dev	Min.	Max.
BS	69	10.05	3.01	5**	17**
BI	69	0.23	0.76	0	1
OC	69	0.13	0.73	0	1
NPL	69	6392.45**	12541.90	12.27	53186.76

**Important facts

Above posed table reveals a clear comparison of the descriptive statistics of the three (Foreign Private Banks, State owned banks and Domestic private banks) different types of banks. Starting from the bard size we observed that minimum board size is 4 which is domestic private banks that maximum board size is 17 from the state owned banks that was pretty expected. As state owned banks there is strong political intervention and always excess staff. If we look critically the second important and our basic variable that is Non-performing Loans (NPL), state owned banks stands at number 1 and is consistent with the previous thoughts that state owned enterprises are inefficient so state owned banks are no exception.

Table 2. Correlation Analysis

	lnNPL	G	BS	BI	OC
lnNPL	1.0				
G	-.09	1.0			
BS	.20*	.11	1.0		
BI	-.16*	.10	.00	1.0	
OC	-.04*	.03	-.05	-.35	1.0

*Important Facts

Starting from the government type (G) we see that dictator type of government have negative correlation (-0.9). It is not unusual because dictator came into power they have very valid argument that democratic government is not performing well so they came forward to protect the national assets of the country. Board size shows the positive correlation (0.20) with the non-performing loans. Board independence as per the expectations showed the negative correlation with the non-performing loans which means outsiders directors monitored tightly and resulted in the reduction of non-Performing loans. In the same line with the Board Independence (BI) showed negative correlation with the non-performing loans.

$$\ln NPL = \alpha + \beta_1 BS + \beta_2 BI + \beta_3 OC + \beta_4 \text{Government Form} + \varepsilon \quad (1)$$

Table 3. Estimation Results of Model-1

Number of Observations		339	
Prob>F		0.00***	
R-Squared		0.7832	
Adj R-Squared		0.7713	
DW Stat		2.09	
lnNPL	Coef.	Std.Err	P>│t│
BS	0.06	0.04	0.02**
BI	-0.04	0.12	0.03**
OC	-0.16	0.09	0.00**
G	-0.21	0.13	0.04**

*significant at 10% only

**significant at 5% and 10%

***significant at 1%, 5% and 10%

This regression tables reveals how corporate governance influence the non-performing loans for the whole banking industry of the Pakistan. The adjusted R-squared (0.7713) shows that model has enough explanatory power. Starting from the board size, we observed that board size has significantly positive influence on the non-performing loans (0.06, 0.02) that is consistent with Gleason (1999); Belkhir (2006). Board size has its own merits and demerits larger board size is fruitful in a way that we have diverse thoughts meanwhile in larger board to get consensus is difficult that is its demerit. So overall we find that banks with the larger board size generate large non-performing loans irrespective of banks ownership. In contrast board independence and ownership concentration shows negative influence on the non-performing loans. The may be true because once the board is independent they do not have any direct or indirect with the business and do the tight monitoring of the banks that resulted in low non-performing loans that is consistent with the literature. On the other hand ownership concentration also has negative influence on the non-performing loans and the higher the concentration higher the accountability of the management. If they do not produce the desired outcome, they might not be elected next time by the shareholders. This voting power of the shareholders forces them to do the good things and produce the profits for them. In banking industry profits are coming from the loans and I they provide the quality loans they could earn more profits. Meanwhile we observed that dictatorship always brings right things for the economy because they are not dependent upon the voting of the general public. They do not need any public support to come in the power. There are many studies showed that in developing countries dictatorship is more effective not only for the nourishing of the banking industry but for the whole economy.

$$\ln NPL = \alpha + \beta_1 BS_{FPB} + \beta_2 BI_{FPB} + \beta_3 OC_{FPB} + \beta_4 \text{Government Form} + \varepsilon \quad (2)$$

Table 4. Estimation results of Model 2

Number of Observations		123	
Prob>F		0.00***	
R-Squared		0.7835	
Adj R-Squared		0.7830	
DW Stat		1.97	
lnNPL	Coef.	Std.Err	P>│t│
BS	0.18	0.07	0.03**
BI	-1.21	0.11	0.00***
OC	-0.76	0.16	0.01***
G	-0.07	0.21	0.21

*significant at 10% only

**significant at 5% and 10%

***significant at 1%, 5% and 10%

This table describes the corporate governance and non-performing loans for the foreign private banks. The overall model is significant with acceptable explanatory power. Board size shows that board size have positive contribution in the non-performing loans of the foreign private banks. Board independence has negative effect on the non-performing loans that are consistent with the literature e.g. Maria et.al (2009). As foreign banks came from the international environment they already have sound experience of the corporate governance, this is the reason why foreign private banks do have more outsider directors on their board and in a result have less non-performing loans. Similarly the ownership of the foreign banks is not distributed in fewer hands their ownership concentration is high and they also well aware of the benefits of the highly concentrated ownership. The results support our hypothesis that higher concentration has negative effect on the non-performing loans and confirms previous arguments made by Azofra&Santamaria, (2011).

$$\ln NPL = \alpha + \beta_1 BS_{DPB} + \beta_2 BI_{DPB} + \beta_3 OC_{DPB} + \beta_4 \text{Government Form} + \varepsilon \quad (3)$$

Table 5. Estimation results of Model 3

Number of Observations		147	
Prob>F		0.00***	
R-Squared		0.7813	
Adj R-Squared		0.7696	
DW Stat		1.93	
lnNPL	Coef.	Std.Err	P>│t│
BS	0.09	0.07	0.00**
BI	-0.42	0.18	0.03**
OC	-0.67	0.21	0.00***
G	-0.56	0.18	0.01***

*significant at 10% only

**significant at 5% and 10%

***significant at 1%, 5% and 10%

This table shows the conditions of the domestic private banks regarding the non-performing loans. Overall model is significant at (1%, 5% and 10%) with the adjusted-R square of 0.7696. We find that Board size has significant positive effect on the non-performing loans as consistent with the foreign private banks in Pakistan and previous studies. We explored that Board independence has significant negative relationship with the non-performing loans

(-0.42, 0.00) that confirms that once there are outsiders on the board there is decrease in the non-performing loans. Similarly ownership concentration highly significant for non-performing loans (-0.67, 0.00) that supports our hypotheses that higher ownership concentration resulted in enhances the loans quality and decrease the nonperforming loans. Dictator form of government is also beneficial for the reduction of no-performing loans in the domestic private banks that is empirically proved (-0.56, 0.01).

$$\ln NPL= \alpha+\beta_1 BS_{SB}+\beta_2 BI_{SB}+\beta_3 OC_{SB}+\beta_4 \text{Government Form}+ \varepsilon \tag{4}$$

Table 6. Estimation results of Model 4

Number of Observations		69	
Prob>F		0.00***	
R-Squared		0.6985	
Adj R-Squared		0.6801	
DW Stat		1.96	
lnNPL	Coef.	Std.Err	P>│t│
BS	0.09	0.09	0.00**
BI	-0.18	0.31	0.02**
OC	-0.67	0.39	0.07*
G	-0.10	0.32	0.05**

*significant at 10% only

**significant at 5% and 10%

***significant at 1%, 5% and 10%

This table describes the relationship of the corporate governance and non-performing loans for the state owned banks of the Pakistan. The table reveals that overall model is significant at 1% and with Adj-R-Square 0.6801.We found that board size has significant positive influence on the non-performing loans is consistent with Gleason (1999); Belkhir (2006) and Altunbas, Gardener, Molyneux and Moore, (2001). Board independence has negative effect on the non-performing loans that supports the existing studiesRaheja, (2005); Harris and Raviv, (2008) and Adams and Mehran, (2003). While the ownership concentration as per expectations showed the negative effect on the non-performing loans. Dictatorship has significant and negative effect of non-performing loans.

5. Conclusion

This paper examines the effect of corporate governance on the non-performing loans of the Pakistani banking industry for the time period of 1996-2007. We find the corporate governance measured by (board size, Board Independence and Ownership concentration) affects the non-performing loans of the Pakistani banking industry. As far as board size, the effect is significantly positive while the board independence and ownership concentration affects non-performing loans negatively. We find some evidence of the Brown and Din ç (2005) who argued that politicians do have influence on the state owned banks and on its credit quality. We find that whenever dictatorship comes in the power things are getting right and there is significant decrease in the non-performing loans of the Pakistani banking industry. Both governing styles democratic and dictatorship have its own advantages and disadvantages. Particularly in developed countries it is assumed that democracy is the good way to govern the country and it is good for the growth of economy. While in developing countries democratic style of government does performed well as evident in the Pakistan. So we conclude here that in Pakistan dictator type of government is in favor of the banking growth that ultimately flourished the economy of the country. This study has some limitations as it considers the banking sector of Pakistan generalization of results for other sectors must be carefully. Secondly to generalize these findings to other country banking sector should be carefully because this study reveals results just in Pakistani Environment and only Pakistani banking industry.

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