Corporate Governance and Risk Taking Behavior of Banks and Financial Institutions in Bangladesh

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Abstract: Banks and Financial Institutions play a crucial role in the economy of all countries. Growth of any economy depends on stability of its financial sector. This research paper shows the stability of financial sector through the corporate governance & risk taking behavior of financial sector of Bangladesh from the year 2000 to 2017. From the Altman z score model, credit risk model & liquidity risk model the soundness of the financial institution's health has been identified. Most of the institutions don't maintain the standard of finance gap, liquidity gap & proper loan deposit ratio. The impact of corporate governance on the advance to deposit ratio demonstrates how aggressive a company to take risk. Random-effects on GLS regression model has been used to fit the dataset. Only the size of the company has significant negative relationship on risk taking ratio which is advance to deposit ratio (ad ratio). The influence of age and board size has insignificant negative relationship on the ad ratio. The number of independent director, board meeting and audit committee meeting has a positive insignificant influence on the advance to deposit ratio of banks & financial institutions of Bangladesh. This paper is bringing some recommendations to improve the stability of the financial sector.

Keywords: Advance to deposit ratio, Corporate Governance of Bangladesh, Risk taking behavior, Risk management of Bangladesh.

1. INTRODUCTION

Corporate Governance (CG) is the set of rules, practices and processes by which a firm is directed and controlled. Corporate governance involves balancing the interests of a company`s stakeholders such as shareholders, management, customers, suppliers, financiers, government and the community. The need for corporate governance arises from the potential conflicts of interest among these parties. Two main reasons for arising these conflicts of interest: First, different goals and preferences of different stakeholders Second, the stakeholder's information gap about each other. Corporate governance is an important issue in modern era that ensures the accountability and responsibility of an organization.

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Banks play a crucial role in the economy of all countries. Growth of any economy depends on stability of its financial sector. In general, banks operate as intermediary between depositors and borrowers. At the present time, banks provide hundreds of services to the customers around the world. It is important to note that these services are vital to our daily life. Financial performance of banks matters, not only for bankers but also for people and government authorities.

Banking is the mostly dominating industry in the financial and economic sectors of Bangladesh.In FY2010-11, financial sector's share in GDP was 2.99 per cent at constant price, which has increased to 3.41 per cent in FY2016-17.Commercial Banks play the dominant role, possess almost 80 per cent of the financial sector. In FY2016-17 the share of banking sector in GDP was 2.91 per cent. The contribution of other financial institutions including non-banking financial institutions (NBFIs) and insurances was only 0.5 per cent of GDP. For that reason corporate governance and risk management is also mostly focus topic for the banking sector in Bangladesh. Strong corporate governance and risk management can enable the company to operate efficiently and effectively thus contribute to the overall economy of Bangladesh. On the other side, weak corporate governance and risk management can`t improve both the individual or overall conditions of an economy.

The advances to deposits ratio (ad ratio) measures loans (advances) as a percentage of deposits. A ratio of 100% or less shows that the bank is funding all its loans from deposits rather than relying on wholesale funding that is funding from the capital markets or other banks.Currently banks and financial institutions are allowed to extend loans up to 83 per cent of their deposits while the allowable limit for a Shariah-based Islamic bank is 6.0 per cent higher. This is an essential measurement as it presents how aggressive a financial institution to lend their fund from the fund of deposits by taking high risk. Both investors and creditors use this figure to take decisions about the company. Investors focus on the solvency and the creditors focus on the debt side of the company to take their decision. So, ad ratio measurement will help both the investors and creditors to take decision about this crucial sector of Bangladesh. It also helps to improve economic conditions of Bangladesh.

2. OBJECTIVES OF THE STUDY
The main objectives of this paper are-
   i.   To examine the behavior of risk taking by commercial banks & financial institutions of Bangladesh.
   ii.   To analyze the impact of corporate governance on the risk taking of banks and financial institutions of Bangladesh.

3. LITERATURE REVIEW
Banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking

services. A bank as a matter of fact is just like a heart in the economic structure and the Capital provided by it is like blood in it. As long as blood is in circulation the organs will remain sound and healthy. If the blood is not supplied to any organ then that part would become useless. A number of recent studies, however, indicate that the banking sector plays a more important role than it was believed earlier.

Alshatti investigated that credit risk is one of the most significant risks that banks face, considering that granting credit is one of the main sources of income in commercial banks. Therefore, the management of the risk related to that credit affects the profitability of the banks.

Aruwa and Musa investigated the effects of the credit risk, and other risk components on the banks' financial performance. They found a strong relationship between risk components and the banks' financial performance.

Ahmed and Uchida define corporate governance that is a mechanism by which companies are governed and/or monitored by the stakeholders: shareholders, auditors, regulators, credit agencies, and so forth.

Gakure et al investigated the effect of credit risk management techniques on the banks' performance of unsecured loans. They concluded that financial risk in a banking organization might result in imposition of constraints on bank's ability to meet its business objectives. According to the results of a survey made to bank senior managers, the three risk factors that most contributed to the financial crisis were inappropriate risk governance, weak risk culture, and ineffective incentive and remuneration policies.

Pi and Timme, Mester, Amess and Drake, Berger and Isik and Hassan studied that efficiency of banks is measured by cost to income ratio, where operating expense is divided by operating income. This ratio is important for determining the profitability of a bank. It can show how efficiently the bank is doing its operations.

Boyd and Runkle found a negative relationship between size and bank performance. This means that large sized banks generate lower level of profits than smaller ones. The negative relationship may happen as large banks may have management issues. Large banks may have an aggressive growth strategy which is obtained at the expense of margins and profitability.
Tarawneh described that larger banks do not always have better financial performance. But most studies suggested that there is a significant relationship between bank efficiency and bank performance.

Shahid found out that codes of good corporate governance present a comprehensive set of norms on the role and composition of the board of directors,

relationships with shareholders and top management, auditing and information disclosure, as well as the selection, remuneration and dismissal of directors and top managers. The codes serve to improve the overall corporate governance of corporations, especially when legal environments fail to ensure adequate protection of shareholders' rights.

Andres and Valleladouse a sample of large international commercial banks to test hypotheses on the dual role of boards of directors. They use a suitable econometric model (two step system estimator) to solve the well-known endogeneity problem in corporate governance literature, and demonstrate the empirical and theoretical superiority of system estimator over OLS and within estimators. They find an inverted U-shaped relation between bank performance and board size, and between the proportion of non-executive directors and performance. Their results show that bank board composition and size are related to directors' ability to monitor and advice management and those larger and not excessively independent boards might prove more efficient in monitoring and advising functions, and create more value.

Levine found out that banks efficiently mobilize and allocate funds; this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. Thus, weak governance of banks reverberates throughout the economy with negative ramifications for economic development. He discussed two special attributes of banks that make them special in practice: greater opaqueness than other industries and greater government regulation. These attributes weaken many traditional governance mechanisms.

4. METHODOLOGY

4.1 Techniques of analysis
In this dataset, both time series and cross-sectional data are included. So, a tool is required to analyze the dataset that considers the problem as well as provide the accurate
solution. Such type of dataset is called panel dataset. That's why the STATA software has been used.
The following steps are followed to get the results of the research on corporate governance & risk management approach of banks & financial institutions-

Advance to deposit ratio is calculated by dividing the total advances by total deposits for a particular period of time. In this study the following equation set to analyze:

ad ratio $= \alpha + \beta_1 *lnta + \beta_2 * age + \beta_3 * boardsize + \beta_4 * inddir + \beta_5 * brd\_meet + \beta_6 * aud\_com\_meet + \varepsilon$ [1]
Here,

      ad ratio = Advance to deposit ratio

α = Intercept
$β_n$= The n coefficients for independent variables
lnta = Log of total asset
age = Learning effect
boardsize = Number of board member
inddir = Number of independent director
brd_meet =Number of board meeting
aud_com_meet = Number of audit committee meeting
ε = Error term

In summary, the following steps are followed to get the optimum results from thestudy:

i.   Firstly, all the required data are put in MS excel and all the calculations were done to make the dataset useable for analysis.
ii.   Secondly, using STATA software to run regression of panel dataset and getsintercept and different coefficient of the variables for both fixed & random effect.
iii. Thirdly, store the fixed & random effect result and run the Housman test to choose proper model to test the data.
iv.   Finally, Determining Random-effects GLS regression is suitable for this dataset.

4.2 Samples of the study
A sample data of 30 banks & 23 financial institutions have been taken to conduct the study. We have taken the data of 53 financial institutions in Bangladesh which are listed in the capital market. Data have been taken for 18 consecutive years-from the year in which the firm has listed in Security Exchange Commission.

4.3 Data Sources
Data is mainly collected from secondary sources for this study. We have collected the data from the annual reports of the respective companies. For this purpose, we have collected the annual reports from 2000 to 2018 of the relative companies after the listing in the stock exchange market. We have collected the annual reports from the Dhaka Stock Exchange (DSE), Lanka Bangla Financial Portal, Bangladesh Securities & Exchange Commission and also visited different online web addresses & the company's website.

5. RESULTS AND FINDINGS

5.1 Descriptive Analysis
Here in this study credit risk and liquidity risk are focused and rest of the risks is not possible to measure because of inadequate information in the annual report.

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5.1.1 Credit risk

It is one of the major risks that commercial banks face. Actually credit risk arises from the potential that a bank's borrower will fail to meet its obligations in accordance with contractual commitment and terms. Credit functions are directly associated with risk. Credits are the largest and most obvious source of credit risk. Credit risk comes from a bank's dealing with individuals, corporate, banks and financial institutions or a sovereign. The risk also originates from both the on and off balance sheet items or activities of the banks. Unwillingness of the borrowers or the customers to repay the due loans sometimes increases the risk. Loan default also relies on how a bank deals with its borrowers. [2]

The Altman Z-Score is a statistical tool used to measure the likelihood that a company will go bankrupt. The Z score models for credit scoring of default risk of financial institutions indicated below:

$$Z = 6.56 * X_1 + 3.26 * X_2 + 6.72 * X_3 + 1.05 * X_4$$

X_1 = working capital/ total assets ratio
X_2 = retained earnings/ total assets ratio
X_3 = EBIT/ total assets ratio
X_4 = equity value / total debt ratio

Different model have different overall predictability scoring. The score for the financial institution bankruptcy measure is given below-

Z- Score	Status
Above 2.6	Healthy position (Bankruptcy is not likely)
1.10 – 2.6	Gray area (Bankruptcy cannot be predicted)
Below 1.10	Unhealthy (Bankruptcy is likely)

In this paper 53 financial companies are taken to conduct the study from 2000-2017. Below shows the result of the study:

Year	Healthy	Gray Zone	Unhealthy
2000	1	1	19
2001	0	2	20
2002	0	2	20
2003	0	3	24
2004	0	2	28
2005	0	1	33
2006	0	3	34
2007	0	3	42
2008	0	2	47
2009	0	4	47
2010	0	3	48
2011	0	3	48
2012	0	3	49

Year	Healthy	Gray Zone	Unhealthy
2013	0	2	51
2014	0	1	52
2015	0	3	50
2016	0	2	51
2017	0	3	49

Table 1: Altman Z-score model result of Banks & FIs.

In this table, the result shows from 2000 – 2017. The financial institution is not healthy from 2000 to 2017; only at the year of 2000 one institution was healthy. And the gray zone is not fluctuated too much. It was within 1 to 4. In the year of 2000, 2005 & 2014 has one institution in the gray area. It was increasing trend in the unhealthy position with the increasing trend of the financial institutions. In the Table, it would be easy to understand.

5.1.2 Liquidity risk

Liquidity risk is the risk that a bank may be unable to meet its short term financial demands. This occurs due to inability to convert a security or hard assets to cash without a loss of capital or income in the process. Well-developed policies for holding liquid assets or having access to markets for purchased funds are normally adequate to meet liability withdrawals. [3]

The banks have short term and also long term crisis. So, it has been used balanced liquidity management model to meet the short term liquidity crisis and financing gap for the long term long period of time. In Balanced liquidity management model, liquidity crisis is met from the assets selling or borrowing funds. The formula for current ratio, liquidity gap & financing gap shown below:

Current ratio = current assets / current liabilities
Liquidity gap= current assets – current liabilities
Financing Gap= Average Loans – Average deposits

The larger the amount of funds the institutions need to borrow in the money markets and the greater is its exposure to liquidity problem from such reliance. A widening financing gap can warn of future liquidity problems for financial institutions since it may indicate increased deposit withdrawals and increasing loans due to increased exercise of loan commitments. The result found in the study is shown below in the form of Table:

Year	Met	Unmet
2000	5	16
2001	10	12
2002	5	17
2003	8	19
2004	9	21

Year	Met	Unmet
2005	7	27
2006	9	28
2007	13	32
2008	9	40
2009	10	41
2010	5	46
2011	9	42
2012	12	40
2013	10	42
2014	7	46
2015	9	44
2016	8	45
2017	6	46

Table 2: Result of Current Ratio of Banks & Financial Institutions.

The number of financial institutions those meet the criteria of current ratio is too low from the study time duration (2000-2017). Here below 1.33 of current ratio consider unmet the criteria of keeping current assets against the current liabilities. The numbers of unmet financial institutions are increasing over the year with the increasing of the financial institutions. And the number of financial institution met the criteria was not much improve from 2000 to 2017. [4]

year	positive	negative
2000	9	12
2001	12	10
2002	10	12
2003	13	14
2004	17	13
2005	12	22
2006	13	24
2007	20	25
2008	18	31
2009	14	37
2010	10	41
2011	19	32
2012	19	33
2013	18	35
2014	15	38
2015	15	38
2016	14	39
2017	13	39

Table 3: Result of Liquidity gap of Banks & Financial Institutions

In this table, the financial institutions had more current liabilities then the current asset. The number of financial institutions of negative figure of liquidity gap is increasing over the year. But after the year of 2013 the number of negative liquidity gap institutions is almost double than the number of positive liquidity gap institutions. [5]

Year	positive	Negative
2000	5	16
2001	5	17
2002	5	17
2003	7	20
2004	7	23
2005	9	25
2006	14	23
2007	16	29
2008	20	29
2009	21	30
2010	24	27
2011	23	28
2012	22	30
2013	22	31
2014	23	30
2015	25	28
2016	25	28
2017	25	27

Table 4: Financing gap result of Banks & FIs.

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The number of financial institutions those had higher average deposits than the average loan is almost double in the time of 2000. After the year 2010, this number is almost equal. In recent years the of financial institutions don`t want to give more loan amount than the amount of their deposits. So, the numbers of negative gap financial institutions are partially reducing with the trend of increasing the institutions.

5.2 Econometric Analysis
Panel data (also known as cross sectional time-series data) is a dataset in which the behavior of entities is observed across time. These entities can be states, companies, individuals, countries etc. In this study, following techniques are focused to analyze the data set.

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i. Hausman test

To decide between fixed or random effects model, run a Hausman test where the null hypothesis is that the preferred model is random effects and the alternative hypothesis is the fixed effects. It basically tests whether the unique errors (u_i) are correlated with the regressors, the null hypothesis is they are not. The result of hausman test in this study is shown below:

	Coefficients			
	(b)	(B)	(b-B)	Sqrt (diag(v_b-v_B))
	Fixed	random	Difference	S.E.
lnta	- 2.344739	-.8165621	-1.528177	1.078307
age	.3342881	-.0143853	.3486734	.2281614
boardsize	-.1300593	-.0710113	-.0590481	.0782854
inddir	.0452422	.1893271	-.1440849	.2814717
brd_meet	-.0609936	.0065179	-.0675115	.0504012
aud_com_meet	-.0073697	.020968	-.0283377	.0491366
Chi2 (6) = 5.25 Prob>chi2 = 0.5119				

Table 5: Results of Hausman test

According to the hausman result in this data set, the probability of the chi square is 0.5119 which is more than 0.05. So, the result of the random effects model is suitable for this data set. [6]

ii. Fixed Effects Model (FE)

Fixed effects use when the impact of variables that varies over time in the data set. The rationale behind is that something within the individual may impact or bias the predictor or outcome variables and need to control for this. Other one is when time variant characteristics are unique to the individual and should not be correlated with other individual characteristics. Each entity is different therefore the entity's error term and the constant should not be correlated with the others. If the error terms are correlated, then FE is no

suitable since inferences may not be correct and need to model that relationship (probably using random-effects), this is the main rationale for the Hausman test.

ad_ratio	coef.	T	P>|t|
Lnta	- 2.344739	-2.10	0.036
Age	.3342881	1.45	0.148
Boardsize	- .1300593	-1.16	0.246
Inddir	.0452422	0.12	0.901
brd_meet	- .0609936	-0.91	0.361
aud_com_meet	- .0073697	-0.09	0.927

ad_ratio	coef.	T	P>|t|
_cons	55.19136	2.37	0.018

R-sq: within = 0.0191		Number of obs = 573	
between = 0.0418		F (6, 514) = 1.67	
overall = 0.0096		Prob> F = 0.1262	

Table 6: Fixed- effects (within) regression on advance to deposit ratio

The probability of the F test in this study is 0.1262 which is not less than 0.05. So the model is not fit for this dataset. And also the errors are correlated with the regressors in the fixed effects model in this dataset. So, we also need to run the Hausman test. [7]

iii. Random Effects Model (RE)

The rationale behind random effects model is that, the variation across entities is assumed to be random and uncorrelated with the predictor or independent variables included in the model. If there is any differences across entities have some influence on dependent variable in the model then it would be wise to use random effects.An advantage of random effects is that it can include time invariant variables.

Table 7: Random- effects GLS regression on advance to deposit ratio without dummy variable

ad_ratio	coef.	Z	P>|z|
Lnta	- .8165621	-2.92	0.004
Age	- .0143853	-0.40	0.690
Boardsize	- .0710113	-0.89	0.376
Inddir	.1893271	0.82	0.414
brd_meet	.0065179	0.15	0.882
aud_com_meet	.020968	0.33	0.740
_cons	22.12448	3.57	0.000

R-sq: within = 0.0118		Number of obs = 573	
between = 0.1682		Number of groups = 53	
overall = 0.0326		Walt chi2 (6) = 15.95	
		Prob> chi2 = 0.0140	

The probability of chi square in the random effects model results is 0.014 which is lower than 0.05. So, the random effects model is fit for this set of data. And also the differences across units are uncorrelated with the regressors.

The independent variables natural log of total asset, age, board size has a negative impact on the depended variables that is advance to deposit ratio (ad ratio). And the number of independent directors, board meetings and audit committee meeting

has positive impact on the advance to deposit ratio. Only the impact of natural log of total asset on risk taking ratio is negative and has a significant impact on the

advance to deposit ratio. The influence of age and board size is negative and insignificant on the ad ratio. And rest of the independent variables that is the number of independent director, board meeting and audit committee meeting has a positively insignificant influence on the advance to deposit ratio of banks & financial institutions of Bangladesh. [8]

ad_ratio	coef.	Z	P>|z|
Lnta	- 1. 083774	-2.60	0.009
Age	- .0022082	-0.06	0.955
Boardsize	- .0788283	-0.97	0.330
Inddir	.2932031	1.12	0.263
brd_meet	-.0025793	-0.06	0.954
aud_com_meet	.0173081	0.27	0.785
dum_fi	-.9610789	-0.87	0.383
_cons	28.92198	2.9	0.004
R-sq: within = 0.0126 between = 0.1681 overall = 0.0339		Number of obs = 573 Number of groups = 53 Walt chi2 (7) = 16.53 Prob> chi2 = 0.0207	

Table 8: Random- effects GLS regression on advance to deposit ratio with dummy variable

The probability of chi square in the random effects model results is 0.0207 which is lower than 0.05. So, the random effects model is fit for this set of data. And also the differences across units are uncorrelated with the regressors. The independent variables log of total asset, age, board size, board meeting and the dummy variable has negatively correlated with the dependent variable that is advance to deposit ratio. Only the independent director and   the audit committee meeting have a positive relationship with advance to deposit ratio. Here also the size of the company has a negatively significant relationship with the advance to deposit ratio. And the rest of the variable has insignificant result with the dependent variable. [9]

6. CONCLUSION

The advance to deposit ratio is the main determinant of aggressive risk taking of financial institutions of Bangladesh & the impact of some variables like age, size, board of directors, audit committee, independent directors, board meeting, audit committee meeting etc. is very much significant. Moreover, corporate governance has profound impact on operating performance of the banks as it controls and monitors the affecting variable of risk taking ratio contributing to superior performance which is examined through econometric analysis. This also ensures proper monitoring and controlling of their investments. [10

It is observed that the independent variables natural log of total asset, age, board size has a negative impact on the depended variables that is advance to deposit ratio (ad ratio) & the number of independent directors, board meetings and audit committee meeting has positive impact on the advance to deposit ratio. Only the impact of natural log of total asset on risk taking ratio is negative and has a significant impact on the advance to deposit ratio. The influence of age and board size is negative and insignificant on the ad ratio. The rest of the independent variables have a positively insignificant influence on the advance to deposit ratio of banks & financial institutions of Bangladesh. The company which has a huge

amount of asset isn't taking more risk by giving loans & advances from the fund of deposits. They should have to maintain the advance to deposit ratio that is 83% for commercial banks & 89% for the Islamic shairia based banks assigned by the Bangladesh Bank. The most of the financial institutions did not able meet the standard level of current ratio. So the corporate governance should be well taken care & proper risk taking behavior should be adopted by the financial institutions for the stability of the financial sector.

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APPENDIX:

1. The following companies are analyzed:

	Bank		Financial Institution
1	AB Bank Limited	1	Bay Leasing
2	Al-Arafah Islami Bank Limited	2	BD Finance
3	Bank Asia	3	BIFC
4	Brac Bank Limited	4	Delta Brac Housing
5	The City Bank Limited	5	Fareast Finance
6	Dhaka Bank Limited	6	Fas Finance
7	Dutch Bangla	7	First Finance
8	Eastern Bank Limited	8	GSP finance
9	Exim Bank	9	ICB
10	FSIBL	10	IDLC
11	ICB Islamic Bank	11	ILFSL
12	IFIC Bank	12	IPDC
13	Islami Bank	13	Islamic Finance
14	Jamuna Bank Limited	14	Lanka Bangla
15	Mercantile Bank Limited	15	Midas Fin

	Bank		Financial Institution
16	**Mutual Trust Bank Limited**	16	**National Housing Finance**
17	**National Bank**	17	**Phoenix Finance**
18	**NCC Bank**	18	**Peoples Leasing**
19	**One Bank**	19	**Premier Leasing**
20	**Premier Bank**	20	**Prime Finance**
21	**Prime Bank**	21	**Union Capital**
22	**Pubali Bank**	22	**United Finance**
23	**Rupali Bank**	23	**Uttara Finance**
24	**ShahjalalIslami Bank**		
25	**Social Islami Bank**		
26	**Southeast Bank**		
27	**Standard Bank**		
28	**Trust Bank**		
29	**United Commercial Bank**		
30	**Uttara Bank**		