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Credit Risk Management: Evidence of Corporate Governance in Banks of Pakistan

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Abstract

The paper evaluates the impact of corporate governance on the Loan Loss Provisions (LLPs) of banks. Linear regression model is applied on a strongly balanced panel data obtained from eighteen commercial banks of Pakistan for the years 2011-2016. The study considers several corporate governance mechanisms such as independent directors, board of directors, Chairman-CEO duality, attendance in board meetings etc. and takes LLPs as proxy for credit risk. Our findings suggest that with reference to Pakistani banks, corporate governance does have an influence on loan loss provisioning. The results clearly indicate that larger boards in Pakistani banks provide ineffective governance through increased loan loss provisioning, while independent directors and director attendance at meetings do not seem to matter. On the other hand where one strong family member dominates, the CEO-Chairman duality appears to induce a reduction in the percentage of LLPs and therefore causes decreases in credit risk. This reflects that the separation of these two positions could lead to higher accountability and responsibility, where there is higher transparency with segregation of duties. The paper concludes that effective corporate governance plays an important role in credit risk management in banks and recommends that regulations are needed to further endorse the validity of CEO-Chairman duality in Pakistan.

Keywords: Corporate governance, loan loss provisions, banking sector of Pakistan, OLS regression

JEL Classification: G21, G32, G34

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Introduction

Corporate Governance (CG) refers to the particular set of policies, customs and frameworks that are difficult to ignore in this modern era of banking, characterized by significant credit risk that decides the continuity of smooth banking operations. Pakistan is a developing country and its advancement depends on the existence of a healthy banking sector which can sustain a much larger default risk as compared to developed countries. The incorporation of risk is only possible by efficient risk management and proper inclusion of non-performing loans as emphasized by the State Bank of Pakistan (Haneef, Rana, Ramzan, Rana, Ishaq & Karim, 2012). Loan loss provision which accounts for credit risk is a good measure to recognize the variation in the credit worthiness of lenders; hence, there is an urgent need of its recognition as a prudent measure of risk management. CG suggests best practices that support transparency, accountability and proper disclosure (Samak, Helmy El Said, & Abd El Latif, 2014) which are fruitful for growth of the banking sector or any other sector. Thus, there must exist an association between LLP recognition and CG best practices which is worth studying with reference to Pakistani commercial banks.

CG best practices help in directing and controlling a company in the best interest of shareholders and stakeholders since CG involves decision making and its implementation. Due to the CG best practices, financial institutions become more accountable in terms of their responsibility towards their owners because their control rests with the management due to change in ownership and control (Shleifer & Wishny, 2012).

Fairness and transparency are the basic requirements that are demanded by depositors with reference to Pakistani commercial banks as these banks are mostly highly leveraged (JCR-VIS Credit Rating Company Limited, 2016) and use borrowed money of their depositors for lending purposes, thus remain accountable to them. With reference to Pakistan, there is still ample room for the CG best practices to gain strength with increasing transparency, accountability and fairness, globally.

State Bank of Pakistan (SBP), the sole regulator of the Pakistani banking sector, has introduced a number of noteworthy measures to promote CG and has enabled these key institutions to promote economic

development by strengthening their positions. These measures include frequent directors' meetings, encouragement to set up committees for; risk management, audit, compensation and nomination, and encouraging directors to continue their professional development related to their job. The separation of the positions of Chairman and CEO and the appointment of independent directors on the board are some key measures taken by the State Bank of Pakistan towards the implementation of corporate governance reforms (Akhtar, 2008).

The SBP is responsible for issuance of the prudential regulations framework for the banking sector. This framework acts as a guiding principle for banks by incorporating international improvements and regulations. Prudential regulations also states the provisioning requirements in the accounts toward the credit risk which is faced by commercial banks (Arby, 2004).

LLPs which represent credit risk provisioning are a cushion to absorb shocks related to advances made to the customers. Thus the provisions that are based on managerial decisions also act as a safeguard for the depositors' money and investments of the shareholders. As CG emphasizes proper disclosures of provisions for enhanced transparency, therefore, commercial banks of Pakistan are bound to adhere to the provisioning requirements mentioned in the prudential regulations (State Bank of Pakistan, 2017) against loans and advances.

Past studies have explored CG in response to credit risk and have found an inverse relationship exists between them. According to our knowledge, there is no study on the relationship in Pakistani commercial banks. So, this study aims to identify the influence of CG on the loan loss provisioning practices with reference to Pakistani commercial banks. The variables selected to capture the effects of CG include independent directors on board, board attendance and Chairman-CEO duality. These are independent variables while Loan Loss Provision (LLP) remains the dependent variable and proxy for credit risk. This study tests the effects of CG on provisions made against the advances and loans provided by Pakistani commercial banks based on the annual report data of eighteen banks from 2011 to 2016.

2. Literature Review

The most recent study of CG and credit risk was conducted on randomly selected 305 non-financial firms (Mudekereza, 2017). Credit risk was measured using credit rating while CG was measured using CEO's incentive compensation. The study concluded that firms with lower credit rating focus more on incentive compensation. This study used credit rating in order to analyze the effect of credit risk as compared to our study which is based on banking provisions for advances. However, we strive to incorporate a number of variables to account for the CG factor. One of these CG variables is board of directors which is significant in terms of risk management. According to Faleye and Krishnan (2017), banks with effective boards are more likely to scrutinize risky borrowers and restrict lending towards them, hence pointing towards credit rationing with the help of CG regulations. Board size and institutional ownership are crucial CG factors in terms of Islamic banking as well. Albassam and Ntim (2017) found positive association of board size and negative association of block ownership with voluntary governance disclosures. It was also found that Islamic banks are more able to sustain risk due to their CG structure in contrast to conventional banks (Mollah, Hassan, Al-Farooque & Mobarek, 2017).o

Similar variables were used in a study that highlighted the CG mechanism and regulations by the Reserve Bank of India in terms of credit risk faced by the public sector banks of India. The study is similar to our study in terms of variables, but our study focuses on the commercial banks of Pakistan due to their deep involvement in advances for which LLPs are maintained, which is our dependent variable. The study used a sample of 26 Indian public banks and proved that there is a significant relationship of CG with LLPs (Layola, Sophia & Anita, 2016).

The study by Switzer and Wang (2013) analyzed the relationship between credit risk and CG from the perspective of creditors by taking into account commercial and savings banks in the US. Their results showed that the CG mechanism affects the commercial banks more as compared to the savings banks, which supports our rationale for choosing commercial banks of Pakistan for our study. Their study also

suggested that banks with larger board size and older CFOs have a lower level of credit risk.

The composition of board and its members are a good measure of CG practices since these factors are widely incorporated by a number of scholars in their studies related to CG. Similarly, we have also used board size and independent directors on board as our CG variables. Erkens, Hung, and Matos (2012) studied the performance of those financial firms which were most affected during 2008-2009 due to financial crisis and they found that the firms with more institutional owners and independent directors had utilized a risk-taking strategy prior to crisis which lead to heavier losses during the crisis. Overall, the authors suggested the existence of correlation between a firm's performance and CG due to risk taking and financing policies.

The financial crisis of 2008-2009 raised a number of concerns related to top management of banks and in this regard considerable literature is available. During the crisis survival of banks was doubtful. However, the existence of strong CG mechanisms in some of the financial institutions enabled them to sustain those shocks. Likewise the study by Aebi, Sabato, and Schmid (2012) found that the financial institutions with their Chief Risk Officer (CRO) reporting to the board rather than to the CEO, had depicted comparatively higher ROE and stock returns in the crisis period.

Also, many scholars highlighted agency problem as a reason for poor CG mechanisms which resulted in ineffective risk management systems. Lang and Jagtiani (2010) also suggested that modern risk management systems would have identified the anomaly which contributed to the crisis at that time. This signifies the importance of CG for effective risk management of banks.

Mudekereza (2017) measured credit risk with the credit ratings of financial institutions. Correspondingly, Ashbaugh-skaife et al. (2006) analyzed the effect of CG on credit rating and they proposed that board independence is positively related with credit rating. They also identified that a weaker governance mechanism can be advantageous for management but costly for stakeholders due to its consequences. This factor leads to resistance from management though shareholders and regulatory authorities emphasize an effective CG monitoring mechanism, which is fruitful for the economy overall.

3. Problem Statement

This study aims to address the correlation that exists between CG and LLPs according to the literature (Mollah et al., 2017). Although the study of CG with reference to LLPs has been conducted on other countries, however to our knowledge no such study exists which focuses on the Pakistani banking sector.

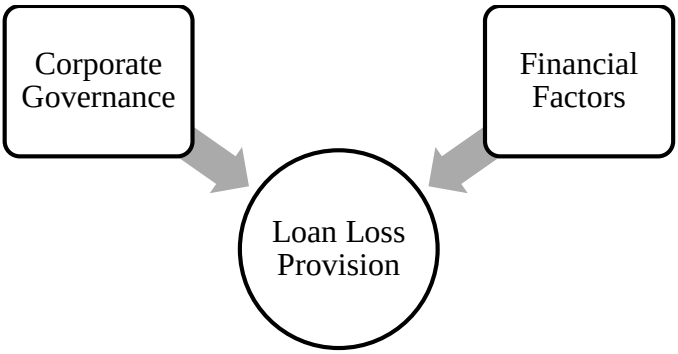

Figure 1. Correlation that exists between CG and LLPs

Keeping in view the risky economy of Pakistan in terms of default risk, it is worth studying the CG mechanisms that play a pivotal role in the monitoring of credit risk through LLPs. In Pakistan as in any other country, the rules and practices as defined by regulator need to be implemented in accordance with CG best practices.

Unlike Pakistan, the recent paper with reference to Indian banking sector also establishes a connection between macro-economic factors such as inflation and market conditions with the LLPs which reflects the financial strength of banks (Mollah et al., 2017).

4. Research Question

In this study we address an important question:
Does corporate governance play a significant role in managing the credit risk of Pakistani commercial banks?

5. Research Design

We used the deductive approach to analyze the impact of CG on credit risk management of Pakistani banks. The sample population consisted of eighteen commercial banks of Pakistan and the data was collected from their relevant annual reports. Although collecting data from annual

reports of banks is common, however, to use this data to evaluate the risk management efficiency of the bank by incorporating LLPs is truly the best estimate regarding the CG best practices.

5.1. Sample

The study focuses on the commercial banks of the banking sector of Pakistan. The sample consisting of top 18 banks is selected based on bank size. Based on their total assets in 2016, the selected banks of our study are classified in four groups (KPMG Taseer Hadi & Co., 2016).

Table 1
Criteria for Banks Selection

Classification	Size of Assets (in Rs. Billion)	No of Banks
1	901-2600	6
2	501-900	4
3	201-500	5
4	130-200	3

5.2. Data and Variables

Data is collected manually for the years from 2011-2016 from each commercial bank's annual report. The details of variables used are given below.

The dependent variable of our study is Loan Loss Provision (LLP), which is a proxy for credit risk, and measured according to the ratio of LLPs to gross loans. Gross loans are used because provisions are incorporated according to gross loans. The higher the ratio the poorer the risk management.

The first independent variable used to evaluate the effect of CG is Board Independence (IND), which refers to the number of independent directors on board, since they are in a position to take strategic decisions and monitor credit risk. The second variable relates to the total number of members on board and is known as Board Size (BOD). This variable is used because it plays a vital role in influencing strategic decision making.

The duality of CEO position is the dummy variable (DUAL) which is 1 if the CEO and Chairman is the same person and zero otherwise. This is a well-known and well-connected variable in terms of CG. Attendance variable (ATT) measures the attendance of directors in

meetings as per 75% and it is the fourth variable. Director's non-attendance shows the inefficiency of the board.

We also used control variables for our study including Bank Size (BAS) which is measured by calculating the total assets of the bank. The bigger the bank the more credit risk it will face. Deposits to Total Assets Ratio (DTR) shows the liquidity and coverage of loans of a bank using its deposits. The next variable is calculated on the basis of the ratio of Total Equity to Total Loans of a bank which evaluates the Shareholders' Influence (SHIN), higher ratio means more protection for deposits and an increased shareholder confidence. Management's Efficiency (MGEF) is calculated as total expense to total income ratio; the lower the ratio the higher the management's efficiency. It is expected that banks would need lesser LLPs considering liquidity, MGEF and SHIN.

Table 2
Variables Description

S. No.	Name	Type	Description
1	LLP	Dependent variable	Ratio of loan loss provisions to gross loans
2	IND	Independent variable	Number of Independent directors on board
3	BOD	Independent variable	Number of directors appointed in a board
4	DUAL	Dummy variable	This is 1, if CEO and chairman of board are same and 0, otherwise
5	ATT	Independent variable	Number of directors who attended less than 75 per cent of board meetings
6	BAS	Independent variable	Total asset of the bank refers to bank size
7	DTR	Independent variable	Liquidity of bank is evaluated by Deposit to Total Asset Ratio
8	SHIN	Independent variable	Total equity to total loans ratio reflects the shareholders influence
9	MGEF	Independent variable	Total expense to total income measures the efficiency of management

6. Instrument Used

Regression analysis is used to estimate the presence of the relationship between one dependent variable and one or more independent variables. It supports the understanding related to changes in the dependent variable, also called criterion variable, due to changes in one independent variable, also called predictor variable, while keeping the role of other independent variables constant.

7. Hypotheses

H_1: There is significant impact of CEO duality on loan loss provision of banks.

H_2: Board size has a significant impact on loan loss provision of banks.

H_3: Attendance of directors in board meetings has a significant impact on loan loss provision of banks.

H_4: Independent directors on board have a significant impact on loan loss provision of banks.

8. Analysis

The relationship of credit risk and CG is assessed using regression, which is given by the equation shown below:

$$LLP = \alpha + \beta_1 IND + \beta_2 BOD + \beta_3 DUAL + \beta_4 ATT + \beta_5 BAS + \beta_6 DTR + \beta_7 SHIN + \beta_8 MGEF + \varepsilon$$

8.1. Descriptive Statistics

Table 3

Descriptive Statistics of Variables

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
LLP	108	19.4485	1.9864	13.8953	22.7661
IND	108	00.2947	0.1430	00.0000	00.6667
BOD	106	02.0374	0.2267	01.6094	02.5649
DUAL	108	00.5648	0.4981	00.0000	01.0000
ATT	108	01.6667	1.7721	00.0000	08.000
BAS	108	26.6666	0.9594	24.5986	28.5502
DTR	108	00.7341	0.1846	00.0003	00.8857
SHIN	108	00.0952	0.1265	-00.0258	00.9863
MGEF	108	02.7160	4.8574	-26.4713	23.6501

Table 3 demonstrates the descriptive statistics of data collected from eighteen commercial banks of Pakistan from 2011 to 2016. The numbers show the minimum, maximum and mean value of the respective variables. There is one dependent variable which is Loan Loss Provision (LLP) and the other variables are independent. The minimum and maximum values of LLP are 13.89 and 22.766, respectively and their standard deviation value is 1.98%, which reflects that LLP deviates 1.98% from the mean value.

8.2. Multicollinearity Test

Below is the VIF table of the variables used in this study. The table shows that there is no issue of multicollinearity as demonstrated below.

Table 4
VIF Table

Variable	VIF	1/VIF
SHIN	1.61	0.6206
DTR	1.54	0.6491
BOD	1.45	0.6577
ATT	1.52	0.6895
BAS	1.18	0.8476
DUAL	1.12	0.8922
IND	1.11	0.8974
MGEF	1.05	0.9484

8.3. Regression Result

Table 5
Regression Results

Source	SS	DF	MS
Model	267.7928	8	33.4741
Residual	153.6837	97	01.5844
Total	421.4165	105	04.0141

Number of observation	=106
F (8, 97)	=21.13
Prob>F	=0.0000
R-Squared	=0.6354
Adj R-Squared	=0.6053
Root MSE	=1.2587

LLP	Coef.	Std. Err.	t	P>|t|	95% Conf.	Interval
IND	-00.0283	0.9367	-0.03	0.976	-1.8875	1.8308
BOD	01.4084	0.6680	2.11	0.038	0.0825	2.7343
DUAL	-00.7029	0.2619	-2.68	0.009	-1.2226	-0.1832
ATT	-0.0362	0.0834	-0.43	0.665	-0.2017	0.1293
BAS	01.3924	0.1401	9.94	0.000	1.1142	1.6705
DTR	02.8866	0.8201	3.52	0.001	1.2588	4.5143
SHIN	02.2545	1.2217	1.85	0.068	-0.1703	4.6792
MGEF	00.0037	0.0258	0.14	0.887	-0.0475	0.0549
_Cons	-22.4668	3.6614	-6.14	0.000	-29.7337	-15.1999

The above table presents the output derived from Stata. Regression results show 60% impact on dependent variable by independent variables. Hence, the appropriateness of the model can be assumed by interpreting the significance value which is 0.000, with 95% confidence level.

9. Interpretation of Results

Our results reflect an insignificant relationship of independent directors with LLPs due to p-value of 0.976, though a notable influence is made by independent directors on board.

Board of Directors (BOD) indicates a positive significant relationship with LLPs as p-value is 0.038. Large size boards show a positive relationship with credit risk with higher loan loss provisioning.

Chairman CEO Duality (DUAL) indicates a significant negative relationship as p-value is 0.009. This indicates a reduction in LLPs with the division of these positions among different persons. This supports governance stance of segregation of the Chairman of Board from firm CEO, results indicate that this duality improves the quality of loans and therefore reduces credit risk, evidenced through lower LLPs.

The p-value of Bank Size (BAS) is 0.000 which is significant and positively relates with LLPs due to the fact that the bigger the bank is, the more it will be in a position to cater the lending requirements of

the Pakistani economy. Hence, the resultant need to recognize LLPs for a larger loan portfolio.

Deposits to Total Loan Ratio (DTR) exhibit a positive significant relationship by its p-value 0.001. The higher the DTR, the more the liquidity of bank will be. It projects the fact that more liquid banks are in a better position to lend and hence they will have to recognize LLPs to account for the relatively risky advancing.

Shareholders Influence (SHIN) is positively and significantly related with LLPs at 10% confidence level. This manifests that the more the influence of shareholder, the more they would like to have LLPs in order to maintain their confidence about the appropriate lending approach of the bank. Therefore the positive relationship may indicate more conservativeness on part of SHIN.

Finally, Attendance in Board Meetings (ATT) and Management's Efficiency (MGEF) both point towards the senior management and their attitude towards the operations of bank. However, we have not been able to prove the relationship of both these variables with LLPs.

10. Discussions and Conclusions

In spite of no prior study about the relationship between LLPs and CG with reference to Pakistani commercial banks, some theories pertaining to other economies reveal a relationship between the two. In the context of our study, there is indeed an impact of CG on LLPs which we evaluated using the mechanisms such as Board Size (BOD) and Chairman-CEO Duality (DUAL). The impact of Chairman-CEO Duality is in accordance with our predication since, a negative relationship of Chairman-CEO Duality with CG shows reduction in credit risk with the separation of Chairman–CEO duality roles. Thus, this study recommends that regulatory authorities make mandatory for all types of banks in Pakistan.

Based on this study, it is advised that risk management practices should be applied properly and supported by an effective CG especially in a complex financial sector like banks. A risk management practice is the key responsibility of the BOD. Without the board's support and direct involvement, there is no chance to enhance the effective CG mechanism and to control the credit risk management practices.

Figure 1 reflects the yearly LLPs of banks of Pakistan. This shows the individual trend of all banks in response to their credit risks measured using LLPs. The spikes indicate higher LLP and hence higher risk portfolio. Figure 2 demonstrates mean LLPs of banks. It suggests that bigger banks have more LLPs since the larger the bank, the more it's lending will be and as a response the higher the number of provisions the bank will recognize. Keeping in view the facts and figures related to this study, it is evident that effective CG has a stronger monitoring role on provisioning. Hence, the paper recommends that the more the bank is involved in lending, the greater is the need to have effective CG best practices.

This research provides guidelines to policy makers. They should enforce more stringent policies to adopt CG best practices which will result in more efficient credit risk management with security for shareholders and a positive impact on the economy. This also adds to the social factor of advances and loans which is needed by Pakistani economy in order to continue developing. This is possible only by an efficient transfer of wealth from surplus to deficit areas, provided there is an effective governance mechanism.

Future research related to this study can be conducted by incorporating all the banks of Pakistan, so that the results can be generalized confidently, considering the fact that CG does impact LLPs.

11. Limitation of the Study

There are some limitations of this study that suggest room for further research:

- Firstly, we collected secondary data of banks for our research which is from 2011 to 2016.
- We limited our sample size to ensure the availability of data as we used eighteen commercial banks of Pakistan. If more banks are selected then the results should be more interesting.
- The variable of the Duality of Chairman and CEO is used in spite of the introduction of policy by Securities and Exchange Commission of Pakistan (SECP) in 2013 which clearly mentions the requirement of their separate roles. Still, we incorporate this variable to evaluate its impact on credit risk as many banks do not clearly impose the separation of this role.

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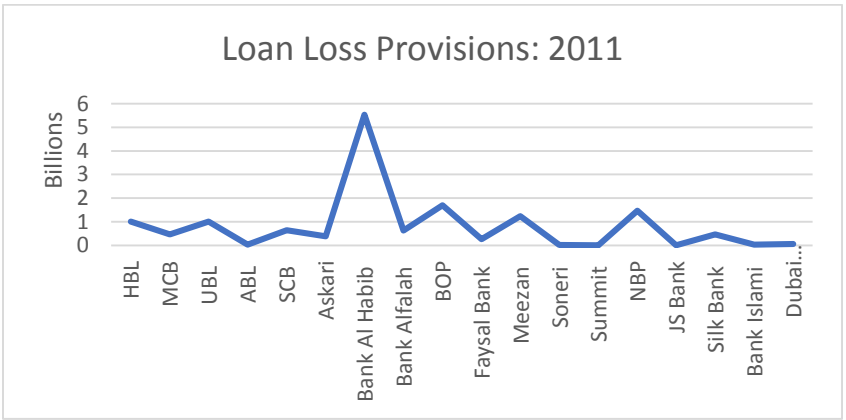
Annexure 1


Loan Loss Provisions: 2011
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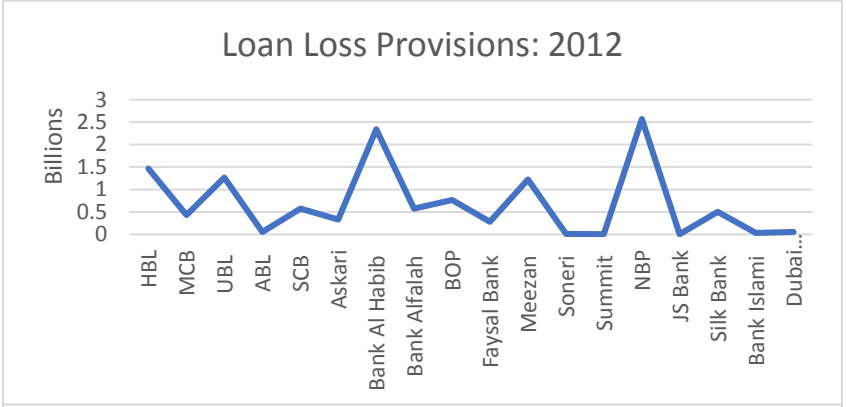
Loan Loss Provisions: 2012
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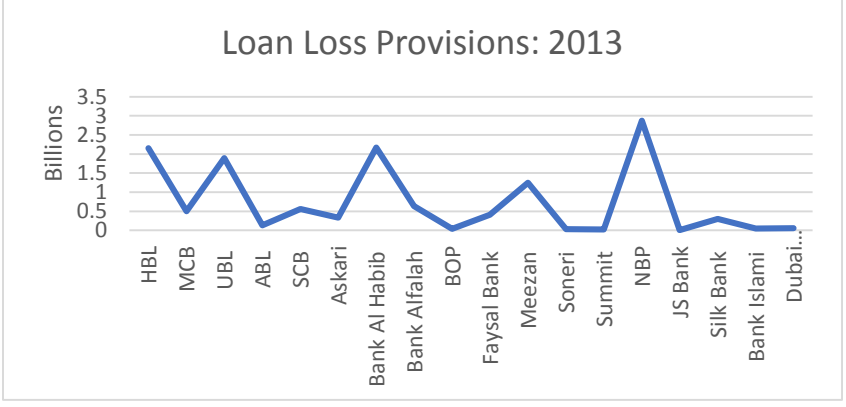
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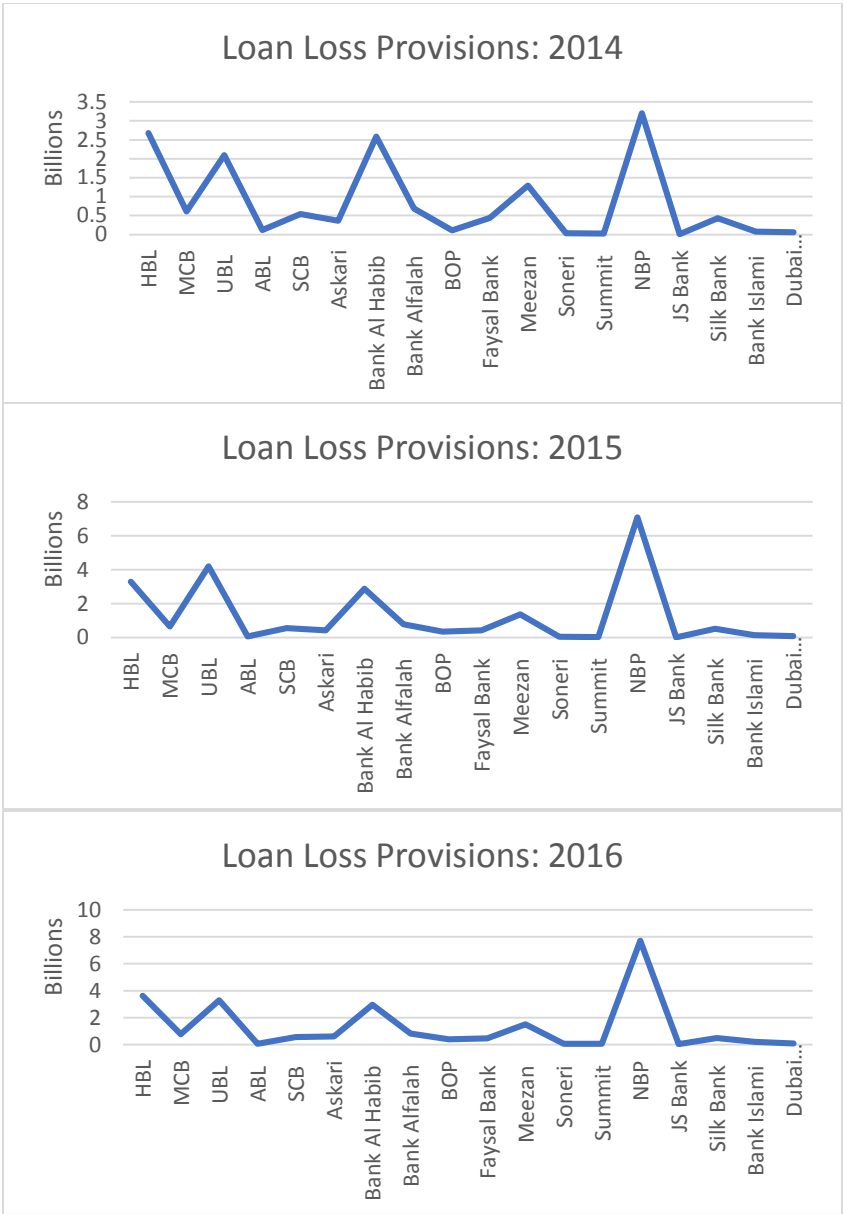

Figure 1: Yearly loan loss provisions

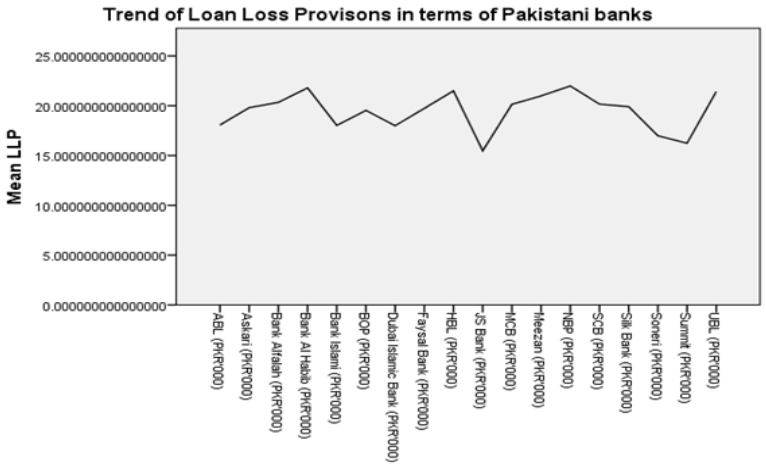

Figure 2. Mean loan loss provisions

Table 6
Sample Banks

Banks of Pakistan	
Habib Bank Limited	Faysal Bank Limited
Muslim Commercial Bank	Meezan Bank
United Bank Limited	Soneri Bank Limited
Allied Bank Limited	Summit Bank
Standard Chartered Bank	National Bank of Pakistan
Askari Bank Limited	JS Bank
Bank Al Habib Limited	Silk Bank
Bank Alfalah Limited	Bank Islami
Bank of Punjab	Dubai Islamic bank

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