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# Governance reforms and performance of MENA banks: Are disclosures effective?

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## 1. Introduction

The past two decades or so have witnessed significant attention, in the academic literature as well as in policy circles, toward understanding the usefulness of corporate governance in banks, especially since the outbreak of high-profile corporate irregularities in several advanced economies and elsewhere.<sup>1</sup> This attention has triggered the formulation of corporate governance codes in several countries, or the revamping of existing codes with a focus on their implementation. Such developments have usually been accompanied by improvements in disclosure standards so as to build investor confidence, augment the depth of financial markets, and protect shareholder and creditor rights.

One region of the global economy where the effect of corporate governance disclosures has been relatively underresearched has been the Middle East and North Africa (MENA). Although some studies have explored the efficacy of such disclosures for the MENA countries (Al-Moataz & Hussainey, 2012; Al-Saeed, 2006; Euromoney, 2007; Piesse, Strange, & Toonsi, 2012; Saidi, 2008; Shehata, 2016), these have mostly been in the nature of documentary evidence or have been based on within-country samples, highlighting the weaknesses in disclosure standards in the countries of the region. Given that the MENA countries have undertaken significant reforms in their corporate governance practices during the past decade, with an associated improvement in disclosure norms, the efficacy of such reforms in affecting bank performance across countries in this region remains an unsettled empirical issue.

To inform this debate, this paper studies the impact of corporate governance reforms and disclosures on bank return and risk for over 100 banks, a quarter of which are Islamic, in 12 MENA countries for the period 2000–2012. The research design exploits the exogenous variation in the staggered implementation of reforms across countries and adopts an appropriate research design to isolate their impact. We examine how different aspects of disclosure practices for banks at the country level affect their performance, after controlling for relevant bank-specific factors as well as country- and year-fixed effects to proxy other, unobservable differences over time and across countries.

A number of factors make the MENA banking sector a useful laboratory to investigate this issue. First, local banks are the mainstay of external finance for corporations in the region, which typically have high family involvement. The close lending relationship means that the focus on disclosure norms is not especially compelling. However, with the introduction of Basel norms, which underscore the importance of risk-based capital assessment for banks, and the increasing emphasis on market discipline, bank disclosures, which were earlier not adequately addressed, have increasingly assumed prominence.

Second, the region has a significant presence of Islamic banks, whose capital structure and asset composition differ distinctly from those of their conventional counterparts (Chapra & Ahmed, 2002; Grassa, 2015; Hassan, 2012). On the liability side, these banks have an extra layer of protection in the form of *mudarabah* savings and investment deposits, based on profit-and-loss-sharing contracts. This extra capital cushion could make these banks relatively more risk averse and thereby take lower risks than their conventional peers, a priori. On the asset side, the relative paucity of Shariah-compliant money market instruments compels them to hold excessive cash balances and constrains their ability to deploy these deposits in the most appropriate manner. Given the competitive

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<sup>1</sup> Investigating entities and reports include, among others, the Blue Ribbon Committee (1999) in the United States, the Cadbury Committee (1992) and Higgs Committee (2003) in the United Kingdom, the Vienot Report (1995) in France, and the Peters Report (1997) in the Netherlands.

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banking markets, these banks are forced to pay returns to fund providers despite getting no (or negligible) return on the underlying assets. As a result, this impairs their ability to undertake disclosure practices on par with conventional banks.

Relatedly, Islamic banks face greater agency problems than conventional banks normally do. In addition to their responsibilities to maximize shareholders' wealth, Islamic banks must comply with Sharia'h practices (Prasad, 2016; Safieddine, 2009), else they face serious reputation risk and potential client flight (Chapra & Ahmed, 2002). Market and operational risks could also be exacerbated by the growing complexity of products and the lack of appropriate hedging instruments. Similarly, asset-based financing often engenders high concentration risks (International Monetary Fund, 2015a, 2015b). All of these factors make disclosures much more challenging for Islamic banks than for their conventional peers.

The implementation of corporate governance legislations also varies markedly across countries. Although most jurisdictions require disclosure of directors' remuneration, in some cases this disclosure is at the aggregate level or is merely advisory in nature. The enunciation of corporate governance policies and corporate ethics as part of transparency and disclosure standards also differs across countries. In Jordan and Kuwait, these disclosures are statutory, but in several other countries, such as the United Arab Emirates and Egypt, they are either voluntary or at best recommended for compliance. This unevenness in the disclosure practices raises the question of how useful they are in influencing bank performance.

Finally, the global financial crisis and the subsequent political turmoil have significantly eroded market confidence and capital flows to the region. The experiences of countries with large and active equity markets suggest that disclosures can powerfully influence firm behavior and safeguard investors' interests. Reinforcing governance standards and enhancing disclosure practices can give potential stakeholders regular, reliable, and comparable information in sufficient detail to enable them to make informed decisions. At the aggregate level, therefore, a strong disclosure regime can enhance confidence and encourage durable capital flows to the region.

The rest of the analysis unfolds as follows. Section 2 presents an overview of the literature and highlights the contribution of the paper. Section 3 summarizes the evolution of corporate governance and disclosure standards in these countries against the backdrop of their banking system. Section 4 discusses the data and methods and section 5 presents an analytical assessment of the results. The final section concludes.

## 2. Background and literature

A number of studies have demonstrated important national differences in the governance structure of firms. In an early exposition, Shleifer and Vishny (1997) provided a comprehensive review of the theoretical and empirical research on corporate governance. Subsequently, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998), La Porta, Silanes, Shleifer, and Vishny (2002) highlighted the importance of legal systems in determining the efficacy of corporate governance.

Three sets of studies have examined how corporate governance and disclosure norms affect performance. The first group, using agency theory, argues that, owing to the separation of ownership and control, agents are less inclined to work in the interests of the principal and in fact often expropriate shareholder wealth. The literature highlights several ways in which such expropriation can occur, such as exploiting of insider information by executives (Chalevas, 2011; Jensen, 1993; Jensen & Meckling, 1976), or excessive remuneration to themselves in the form of salaries and bonuses (Bebchuk & Fried, 2002; Shleifer & Vishny, 1997). To address this concern, shareholders need to use governance mechanisms that can lead to a net decrease in agency costs—including enhancing disclosure norms so as to exercise checks and balances on the agent (Fama & Jensen, 1983; Siddiqui, Razaq, Malik, & Gul, 2013). This induces rational managers to fulfill their function of maximizing shareholder value, in turn improving performance.

A second set of studies is based on resource dependency theory, which links the firm to its financial and nonfinancial resources (Chen & Roberts, 2010; Pearce & Zahra, 1992). These studies contend that having a large number of directors not only strengthens the board's monitoring of the firm, but also provides critical resources such as business contacts, domain knowledge, expertise, and experience (Bouwman, 2011; Chen, 2011). In addition, the board of directors also represents the interests of varied stakeholders—such as the government, local communities, employees, suppliers, customers, and regulators—who are directly or indirectly involved in the fortunes of the company (Hillman & Dalziel, 2003). The combined expectations of these stakeholders may impel the board to disclose greater information and thereby achieve competitive advantage by encouraging additional perspectives (Adams & Mehran, 2012; Ruigrok, Peck, & Keller, 2006).

A final line of research, based on stewardship theory, views agents as trustworthy stewards who manage the firm responsibly in order to improve its performance (Muth & Donaldson, 1998). This theory argues that agents have access to much better information about the firm than owners do, which makes agents best suited to use its resources in a way that maximizes firm value (Davis, Schoorman, & Donaldson, 1997; Nicholson & Kiel, 2007), and that they will do so because any misconduct might adversely affect firm reputation and jeopardize their career prospects. One possible way to augment reputation is by enhancing disclosures so as to keep all stakeholders well informed about the firm's activities.

The extant economic literature on the cost-benefit calculus of disclosure is ambiguous, at best. On the one hand, the “disclosure-stability” argument contends that greater disclosures enhance transparency, thereby lowering informational asymmetries and enabling efficient allocation of resources by fostering market discipline. As a result, greater disclosures allow less risky banks to enjoy lower financing costs and reduce their probability of default (Beck, Demircuc Kunt, & Levine, 2006). On the other hand, the “disclosure-fragility” argument observes that greater disclosures provide detailed information about bank financials, some of which could be misinterpreted by the market, thereby depleting investors' confidence and triggering a run on the bank or engendering a stock

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