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Corporate Governance and Performance of Private Domestic Banks in Sri Lanka: Current Status and Areas for Reforms

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Abstract

The stability of the banking sector is of utmost importance for the economic and financial development of a country. However, the stability of the banking sector become an issue due to sudden failures of banking institutions. With that, corporate governance has been identified as a mechanism which can be used to prevent such failures since it has the ability to improve the governance structure and thereby the soundness and healthiness of banks. Therefore, corporate governance has been introduced and promoted among banks all over the world during the last few decades. Accordingly, this study investigates the impact of introducing corporate governance principles on PDBs of Sri Lanka during the period from 2004 to 2015.

This study focuses on four objectives, and mixed methods of research are employed to achieve these objectives. In relation to the first and second objectives, quantitative research method is employed. i.e. 1). to examine the level of compliance on corporate governance by PDBs of Sri Lanka; and 2). to investigate the impact of individual corporate governance mechanisms and the level of compliance on the performance of PDBs of Sri Lanka. CGCI was constructed by the researcher to measure the level of compliance. Panel data regression analysis was employed to examine the impact of corporate governance on the performance of PDBs of Sri Lanka and data was collected from the annual reports of the individual banks.

In relation to the third and fourth objectives, qualitative research method is employed. i.e. 1). to assess the adequacy of existing corporate governance framework of PDBs of Sri Lanka based on the views of experts and professionals; and 2).to invite attention of policy makers and regulators to revisit the existing corporate governance codes and to improve the corporate governance culture of PDBs. Perception of the experts and professionals was obtained by way of semi-structured interviews conducted by the researcher and thematic analysis was employed as the analytical tool.

This study is unique, as there are many findings in relations to the different aspects. The findings with regard to the level of compliance are as follows: 1).The level of compliance on PDBs of Sri Lanka has gradually improved during the period from 2004 – 2015. 2).The degree of improvement of the level of compliance during the said period is different. 3). There is an impact of introducing mandatory corporate governance principles for the improvement of level of compliance. 4). Level of compliance on voluntary corporate governance codes are high in developed countries when compared with developing countries like Sri Lanka 5). Level of compliance on corporate governance during the period of voluntary corporate governance (i.e. from 2004 – 2007) by PDBs of Sri Lanka is below the average level. 6). There is no sudden or significant improvement immediately after the introduction of mandatory principles of corporate governance to the PDBs of Sri Lanka. 7). Even though mandatory legal requirements are imposed to improve the corporate governance frameworks of banks, it takes considerable time to implement and comply with the same. 8). No regulatory action was taken for non-compliance of mandatory corporate governance requirements and published the same, as required by law.

Four models were developed using panel data regression analysis, to find the relationship between corporate governance variables and performance variables. The summary of the findings under these models are as follows. Firstly, it was empirically found that there is no statistically significant relationship between the number of directors and the performance of PDBs of Sri Lanka during the total and mandatory period of corporate governance. However, it was found that there is a statistically significant negative relationship between the number of directors and the performance of PDBs during the voluntary period of corporate governance. Secondly, it was found that there is a significant positive relationship between the proportion of independent non-executive directors and the performance of PDBs of Sri Lanka, except for the negative relationship found during the voluntary corporate governance period. Thirdly, the findings show that there is a negative relationship between the female presence in the board and performance of PDBs during the period of voluntary corporate governance. Fourthly, it was found that the ownership concentration (i.e. total shareholding of the five largest shareholders of banks)

has a significant negative impact on the performance of PDBs of Sri Lanka. The fifth finding was that the level of compliance as measured by the CGCI has a positive impact on the performance of PDBs. Next, as the sixth point, it was found that the existence of IRMC has a positive impact on the performance of PDBs relating to capital adequacy in both total and mandatory periods of corporate governance.

Further to above, survey was carried out by way of semi-structured interviews to find the views of experts and professionals in the area of corporate governance and their suggestions are as follows: Regulator should be empowered to interview the directors to be appointed to banks, fit and Proper criteria of the directors should be properly defined (e.g. “any other relevant discipline), directors should be given proper training on corporate governance, proper procedures and mechanisms should be introduced for recording board minutes, measures should be introduced to identify the indirect relationships and shareholdings, cooling off periods should be introduced to the KMPs to be appointed to banks, presence of the executive members in IRMC and Audit committee should be limited to by invitation, compliance officer should be given proper authority, functions of the nomination and remuneration committee should be revisited, more weightage should be given for systematically important banks in relation to the supervision and monitoring of CG related matters, and proper mechanism should be introduced to execute the corporate governance principles.

Based on all these findings and the suggestions of the experts and professionals, few recommendations were also made in this thesis to the attention of the policy makers and regulators.