

The Role of Corporate Governance in Enhancing Financial Stability in Banking

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Abstract: *The purpose of this research is to investigate corporate governance practices and how they affect commercial banks' performance when there is no formal stock market. The research evaluated how certain internal and external corporate governance practices related to bank performance as determined by ROE and ROA. Structured document review was employed in the research, and financial data from commercial banks was gathered between 2005 and 2011. The results showed that although bank size had a statistically significant beneficial impact on bank performance, board size and the presence of an audit committee on the board had a statistically significant negative impact. In a similar vein, the capital adequacy ratio, which is a gauge of external corporate governance mechanisms, significantly improved bank performance. Furthermore, the main factors negatively affecting corporate governance and bank performance in Ethiopia are the lack of an organized stock exchange, excessive government intervention, a lack of awareness of corporate governance, the absence of national standards for corporate governance, accounting, and auditing, and a weak legal framework protecting the rights of minority shareholders.*

Keywords: Risk Management, Regulatory Compliance, Transparency and Disclosure omy

I. INTRODUCTION

Because ownership and control are separated in publicly traded corporations, corporate governance is crucial. In corporations, shareholders (principals) assign decision-making authority to management (agents) with the expectation that the agents will act in the principals' best interests. The "agency problem" occurs when the agents fail to act in the principals' best interests or when they prioritize their own interests over those of the shareholders [1] and [2]. Thus, the main goal of implementing sound corporate governance is to reduce the possibility of shareholder loss as a result of conflicts of interest between management and shareholders [3]. The shareholders of corporations elect and appoint members of the board of directors to oversee management's conduct and make strategic decisions about the company on their behalf. This is the main way that shareholders reduce this conflict of interest. Effective company governance boosts investor trust and increases economic efficiency and growth [4]. Additionally, it decreases the cost of capital, improves operational performance, and expands enterprises' access to external finance [5]. Additionally, [6] showed that investors are prepared to shell out hefty sums for businesses with strong corporate governance. Therefore, it may be said that improved corporate governance will result in both higher company value and improved firm performance.

Although academics in industrialized economies have produced a sizable body of work on corporate governance, there aren't many studies on the subject in developing nations [7] and [8]. [9] said that whereas prior empirical research has shown the connection between corporate governance and business success, opinions on how corporate governance affects firm performance remain divided. There are relatively few previous studies on corporate governance in Ethiopia, and none of the ones that have been done (such as [10] and [11]) have tried to analyze how corporate governance affects bank performance. Furthermore, given Ethiopia's lack of a capital market, it would be intriguing to learn more about the structure of corporate governance there.

Thus, the impact of both external and internal corporate governance measures on bank performance is investigated in this research. Based on financial and non-financial data gathered from all commercial banks operating between 2005 and 2011, the research used panel data econometric analysis.

The results showed that bank size and the capital adequacy ratio had statistically significant positive effects on bank performance, whereas board size and the presence of an audit committee on the board had statistically significant negative effects.

This is how the remainder of the paper is structured. A overview of relevant literature is presented in Section 2. The data and study technique are described in Section 3. Results and discussion are covered in Section 4. Finally, the conclusion is presented in Section 5. The results' policy implications are presented in Section 6.

II. LITERATURE REVIEW

2.1 Review of Theoretical Literature

Regarding the nature and importance of corporate governance, a number of ideas have been developed. These theories include, among others, agency theory, stakeholder theory, and stewardship theory, all of which are briefly discussed in the paragraphs that follow.

Agency Theory: A lot of people utilize agency theory to explain different corporate governance problems. The separation of ownership and control in huge organizations is the foundation of the notion. To maximize return to shareholders, managers (agents) are employed by these organizations to work and make decisions on behalf of the owners (principals) [1]. However, when the agent acts to maximize their own worth rather than the principal's best interests, a conflict of interest between the two parties is unavoidable [1]. Managers and shareholders may have different aims as a result of this conflict of interest, which arises from differences in their desired amount of management effort, attitude toward risk, and time horizons [3]. In order to align the interests of management and shareholders, several control systems, either internal or external to the company, need be implemented [3]. However, [12] contend that the assumptions made in agency theory regarding individualistic utility motivation leading to principal-agent interest divergence might not apply to all managers; as a result, it is not desirable to rely solely on agency theory because it fails to take into account the complexity of organizational life.

Stewardship theory: In contrast, the stewardship hypothesis has its roots in psychology and sociology. In contrast to the agency theory, which asserts that conflicts of interest between managers and shareholders are unavoidable unless suitable control mechanisms are established to align the interests of managers and shareholders [1], the stewardship theory maintains that managers are stewards whose motivations are in line with the goals of their principals—shareholders [12]. According to the stewardship approach, managers who are stewards are content and inspired when the company succeeds, even if it means sacrificing their own objectives [2]. Additionally, although the agency theory contends that separating the CEO and board chair positions will safeguard shareholder interests, the stewardship theory contends that appointing the same individual to both positions will maximize shareholder interests by granting the CEO greater authority and responsibility as a steward within the company [13].

Stakeholder theory: The stakeholder theory is the other widely accepted philosophy of corporate governance. The management discipline served as the foundation for the stakeholder theory, which progressively expanded to include corporate responsibility to a wide variety of stakeholders [2]. Stakeholder theory contends that managers in organizations are accountable not only for the interests of shareholders but also for a network of relationships to serve, which includes suppliers, employees, and business partners, in contrast to the agency theory, which holds managers primarily responsible for meeting the interests of shareholders [2].

Stakeholder theory states that choices made about the firm have an impact on a variety of parties, including the company's stockholders. Therefore, managers must act as the company's agent to ensure the survival of the business and protect each group's long-term stakes, while also managing the business to benefit its stakeholders in order to protect their rights and participation in decision-making [14]. As a result, the main argument in corporate governance, according to [15], is whether corporate governance should just defend the interests of equity holders in the company or should it also address the issues of other stakeholders.

2.2 Review of Empirical Literature

To determine how internal and external corporate governance processes affect bank performance, different researchers use various proxies. The size and makeup of the board are two of the most often utilized internal governance variables. However, as seen below, the findings of earlier research are not conclusive. [16] looked at how the government affected Jordanian commercial banks' performance.

He examined how the bank's performance, as determined by Tobin's Q, was affected by governance factors such board size, CEO duality, the proportion of non-executive directors, capital sufficiency, the ownership percentage of significant shareholders, and the ownership percentage of the largest shareholder. He discovered that although leverage had a statistically significant detrimental impact on performance, CEO duality and the proportion of nonexecutive directors had a statistically significant beneficial impact. And [16] came to the conclusion that, in addition to CEO duality, ownership concentration, capital sufficiency, and the proportion of non-executive directors are acknowledged as significant factors that influence banking performance. [17] also looked into how corporate governance affected Nigerian banks' performance and found that, in contrast to what [16] had shown, board size and chief executive position improved performance. In a similar vein, [18] used 348 Australian listed businesses to examine the connection between board makeup and company success.

They demonstrate a substantial positive relationship between market-based measures of business performance and board size and the percentage of inside directors. These findings are corroborated by [19], who discovers a strong negative correlation between the amount of related-party loans and bank performance and a significant positive correlation between board size and bank performance.

The connection between external corporate governance procedures and bank performance has been the subject of another aspect of the literature on bank corporate governance and performance. [20] We examined the connection between risk management, corporate governance, and bank performance in the Indonesian banking industry. They use return on equity (ROE), net profit margin (NPM), value at risk (VAR), and capital adequacy ratio (CAR) to assess external business practices, risk management, and bank performance, respectively. They discovered that the kind of bank ownership has an impact on the link between corporate governance and risk management as well as between corporate governance and bank performance. Additionally, bank performance is significantly impacted by risk management, and vice versa.

Additionally, they discovered a nonlinear correlation between ROE and CAR. Similar to this, [21] used annual data from 11 banks over the years 1995–2005 to examine the connection between corporate governance and bank performance in Malaysia before and after the Asian Financial Crisis. They discovered proof that CAR performs much better in relationships. [21] It was also shown that foreign-owned banks outperform locally held private banks in terms of corporate governance. [22] Additionally, an attempt was made to approach the problem from a somewhat different perspective.

Using a questionnaire with a 5-point Likert scale to gather information on the opinions of 388 respondents, he examined the corporate governance and financial performance of a few Ugandan commercial banks from the viewpoints of bank personnel and depositors. Additionally, he employed the CAMEL framework as a measure of bank performance and variables like trust, disclosure, and financial transparency as a measure of corporate governance. He came to the conclusion that these factors significantly improve the performance of commercial banks. However, there are methodological issues with the way the statistical methods were used in his work.

According to the aforementioned research, there is broad agreement that effective corporate governance enhances business performance, but there is less agreement on the specific processes by which corporate governance influences firm performance. Because of this, more empirical research on the topic is needed. Additionally, the majority of earlier research was conducted in countries with capital markets, thus the results may not be applicable in places like Ethiopia without a formal stock exchange market. Therefore, by evaluating a few internal and external corporate governance systems and their impact on commercial banks' performance, this research attempts to close this gap in the literature.

2.3 The Hypotheses

Because banks are heavily regulated by the government and have depositors in addition to stockholders, their corporate governance may vary from that of other businesses [20].

Therefore, [15] suggests that in the case of banks, a more comprehensive approach to corporate governance should be used. Both internal and external corporate governance processes are a part of bank corporate governance. The composition of the board of directors and how well they oversee the bank's operations are examples of internal

corporate governance procedures. In contrast, the market for corporate control and government rules and oversight are examples of external corporate governance processes [20] and [23].

Prior research on internal corporate governance examined the size, independence, structure, activity, and salary of the board of directors in order to determine how these factors affected performance (e.g. [18] and [17]). The size of the board may thus be a significant governance factor, according to [24]. For both the company's success and sound corporate governance, the ideal board of directors size should be determined. Consequently, the first hypothesis is expressed as follows:

H1: Bank performance and board size are positively correlated.

Because the audit committee helps the board carry out its oversight duties by reviewing the financial data and internal control systems, as mentioned in [25], "market regulators, commissions, and accountancy bodies have recommended the establishment of audit committees as an important step in improving corporate governance." Thus, the second hypothesis is expressed as follows:

H2: The performance of banks is positively correlated with the presence of an audit committee on the board.

There are external corporate governance measures that are crucial in lowering the agency issue in banks, but good corporate governance is not just the outcome of internal corporate governance systems. To protect the interests of depositors and the public at large, the government imposes comparatively stricter regulations on the banking industry. The impact of the market for corporate control on corporate governance may be negligible in nations without a capital market, such as Ethiopia. Rather, a key role in bank governance is played by government regulation and oversight as an external corporate governance mechanism. As a result, external corporate governance is seen as a system that assigns the government's duty to regulate bank activities via existing bank rules [20]. Several financial parameters of individual banks, such as the capital adequacy ratio (CAR), loan loss provision (LLP), loan to deposit (LTD), liquid asset to total asset, and others, are used by central banks to exercise regulation. Among these measures, the CAR of individual banks in particular is a reliable predictor of how well corporate governance practices are being implemented inside the bank [20]. [26] also discovered that commercial banks' risk-taking behavior is decreased when the capital adequacy rule is implemented. As a result, the third hypothesis is as follows:

H3: Bank performance and external corporate governance procedures, as determined by CAR, are positively correlated. Other models pertaining to external corporate governance exist in addition to CAR. These include the following: loan to deposit ratio (LDR), loan loss provision (LLP), cash claim on central bank (CCC), second-ary reserve ratio (SRR), capital ratio (CR), and fixed assets and inventories to capital (FAI). This research also made use of the loan to deposit ratio (LDR), capital adequacy ratio (CAR), capital ratio (CR), and loan loss provision (LLP). Therefore, the following hypothesis may be made:

H4: The loan loss provision and bank performance are negatively correlated.

H5: The capital ratio and bank performance are positively correlated.

H6: The loan-to-deposit ratio and bank performance are negatively correlated.

III. DATA AND METHODOLOGY

The Data

Two sources provided the data for this investigation. The National Bank of Ethiopia (NBE) provided the banks' audited yearly financial accounts for the years 2005–2011. Every bank in the research provides information on board characteristics. Nine commercial banks were included in the research, two of which are state-owned and the others are private. As a result, panel data from nine commercial banks spanning seven years (63 observations) was utilized in this investigation.

Methodology

Multivariate regression analysis and descriptive and inferential statistical analyses were part of the quantitative data analysis approach. The means and standard deviations of the regression variables were examined using descriptive statistics. Additionally, a number of tests were performed on the assumptions of the Classical Linear Regression Model (CLRM) prior to doing regression analysis. To determine how corporate governance practices affected bank performance, the following two regression models were employed:

$$\text{Model 1 ROE} = a_0 + a_1\text{BDSZ} + a_2\text{AUDC} + a_3\text{CAR} + a_4\text{CR} + a_5\text{LLP} + a_6\text{LDR} + a_7\text{BKSZ} + a_8\text{OWTP} + a_9\text{CAR}^2 + E.$$

$$\text{Model 2 ROA} = a_0 + a_1\text{BDSZ} + a_2\text{AUDC} + a_3\text{CAR} + a_4\text{CR} + a_5\text{LLP} + a_6\text{LDR} + a_7\text{BKSZ} + a_8\text{OWTP} + a_9\text{CAR}^2 + E.$$

Where:

ROE is the return on equity

ROA return on asset

BDSZ board size representing the number of directors sitting in the board

AUDC existence of audit committee in the board, dummy variable taking 1 if there is audit committee in the board, and 0 otherwise.

CAR capital adequacy ratio year-end capital of the bank divided by year-end total risk-weighted assets of the bank

LLP loan loss provision allowance for loan loss divided by year-end total loans

*CAR*² is the square of capital adequacy ratio

This study uses two control variables, namely, ownership type (OWTP) and bank size (BKSZ).

BKSZ is bank size measured as a log of the year-end total assets.

OWTP is ownership type with dummy variable taking 0 if the bank is a state-owned and 1 otherwise.

Tests for the Classical Linear Regression Model (CLRM) Assumptions

A constant term is included in the model to satisfy the first assumption of the CLRM that the expected value of the errors must be zero. The test of heteroskedsticity has been used to verify the assumption of a constant variance of error terms. There is no indication of heteroskedasticity, according to the test statistic's F and χ^2 versions. The Durbin-Watson (DW) Test was used to verify the third assumption of uncorrelated error terms. However, the result is inconclusive in this case i.e. the null hypothesis is neither rejected nor accepted. According to the fourth assumption, there should be no correlation between the regressors and the error terms.

If the first assumption—that the expected value of errors is zero—is true, then this assumption is not broken [27]. The residuals are normally distributed, and CLRM also assumes a normal distribution in order to allow for a reliable determination of the coefficient parameters. The histogram for residuals is almost bell shaped with mean of 4.70e-17, and standard deviation of 0.049, and the Jarque-Bera statistic of

4.9 is not significant at 5%; implying that the null of normality is not rejected. Absence of multicollinearity among independent variables has been evaluated using Pearson's Correlation Matrix, and we observed that all regressors except CAR and CR (with correlation coefficient of 0.91), have a correlation coefficient less than 0.8. CR is removed from the regression model as a solution to the high correlation between CAR and CR. Lastly, the Hausman test was used to determine whether panel regression model—the fixed effects model (FEM) or the random effects model (REM)—was best, and REM was chosen.

Findings and Conversation

IV. DESCRIPTIVE STATISTICS

Table 4.1 gives the descriptive statistics for the variables in the research based on panel data of the banks from the year 2005 to 2011. The table provides the mean, and standard deviation including minimum and maximum values of regression variables.

Table 1. Descriptive Statistics of regression variables

Variable	State (N=14)		Private (N=49)		Total sample (N=63)		Min	Max
	Mean	Std.Dev.	Mean	Std.Dev.	Mean	Std.Dev.		
ROE	0.36	0.10	0.24	0.10	0.27	0.11	-0.04	0.55
ROA	0.03	0.01	0.03	0.01	0.03	0.01	-0.02	0.05
CAR	0.13	0.04	0.25	0.19	0.23	0.18	0.08	1.25

CR	0.31	0.09	0.32	0.17	0.31	0.15	0.14	0.98
BDSZ	7.79	2.33	9.65	1.84	9.24	2.09	5.00	12.00
AUDC	0.50	0.52	0.65	0.48	0.62	0.49	0.00	1.00
OWTP	0.00	0.00	1.00	0.00	0.78	0.42	0.00	1.00
LLP	0.11	0.06	0.04	0.02	0.05	0.04	0.00	0.21
LDR	0.65	0.30	0.70	0.19	0.69	0.22	0.20	1.30
BKSZ	23.15	1.66	21.91	0.96	22.18	1.25	18.68	25.46

According to the descriptive data, the mean CAR of private banks is 25%, while that of state-owned banks is 13%. This suggests that private banks are generally more conservative when it comes to capital adequacy. The average CAR for the electronic banking industry is 23%, which is higher than the 8% minimum CAR mandated by the Basel Accord and the NBE. Private banks have a larger board than their state-owned counterparts, with a mean board size (BDSZ) of 9.65 as opposed to 7.79 for state-owned banks. On average, throughout the research period, all of the sample banks had an audit committee in the board of directors (AUDC) 49% of the time. This is because some of the banks have established audit committee very recently and some don't have it at all.

The mean loan loss provision (LLP) for the state-owned banks and private banks and total sample banks is 11% and 4% respectively. These show that management of private banks is less willing to take risks than that of state-owned banks. The mean loan to deposit ratio (LDR) of state-owned banks is 65%, while that of private banks is 70%. This indicates that private banks are more dependent on depositor funds to make loans. Bank size (BKSZ), shows that state-owned banks have larger mean total assets (23.15) than private banks (21.91), which is partly due to the fact that the largest bank in the sample is a state-owned bank. Lastly, state-owned banks perform better than private banks, which have a mean ROE of 24%, with a ROE of 36%. However, the two types of banks have equal performance when measured in terms of average ROA (i.e. 3%). According to descriptive data, private banks generally have lower LLP and higher CAR, CR, and AUDC than state-owned banks. This suggests that private banks are more focused on putting strong corporate governance into practice.

Regression Results

The multiple regression results of the study are presented in table, 4.2 and table 4.3 for model 1 and model 2 respectively. Using ROE as the dependent variable and additional governance and control variables as regressors, the regression output is displayed in Table 4.1. With R-square and adjusted R-square of 0.68 and 0.63, respectively, the regression output shows that the explanatory variables in the model adequately explain the dependent variable. The F-statistic of 14.57 is also significant with P-value of zero, suggesting that variations in the dependent variable are adequately explained by the regressors in the model.

Table 2. Regression Result for Model 1

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CAR	-0.4418	0.1847	-2.3917	0.0203**
BDSZ	-0.0107	0.0049	-2.1964	0.0324**
AUDC	-0.0437	0.0191	-2.2876	0.0261**
OWTP	0.0199	0.0340	0.5852	0.5609
LLP	0.1663	0.2876	0.5784	0.5654
LTD	0.0933	0.0582	1.6049	0.1143
BKSZ	0.0644	0.0134	4.7968	0.0000****
CAR2	0.3070	0.1449	2.1186	0.0387**
Weighted Statistics				



R-squared	0.683372		
Adjusted R-squared	0.636465		
S.E. of regression	0.068468		
F-statistic	14.56842	Durbin-Watson stat	1.67706
Prob(F-statistic)	0.0000		

***, **, indicates significant at 1%, and 5% significance level respectively.

Explanatory variables like capital adequacy ratio (CAR), board size (BDSZ), and the presence of an audit committee (AUDC) have a statistically significant negative impact on bank performance, according to the regression results in Table 4.2. In contrast, the square of the capital adequacy ratio (CAR2) and bank size (BKSZ) have a statistically significant positive impact on performance as determined by ROE.

The regression findings for the second model, in which ROA is a dependent variable, are as follows:

Table 3. Regression Result for Model 2

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.06624	0.036312	-1.82405	0.0737*
CAR	0.044593	0.019324	2.307658	0.0249**
BDSZ	-0.00111	0.000508	-2.185153	0.0332**
AUDC	-0.00512	0.001999	-2.559854	0.0133**
OWTP	0.005264	0.003561	1.478264	0.1451
LLP	-0.02403	0.030083	-0.798607	0.428
LDR	0.004289	0.006084	0.70495	0.4839
BKSZ	0.004365	0.001404	3.109833	0.003***
CAR2	-0.05742	0.01516	-3.787429	0.0004***
Weighted Statistics				
R-squared	0.522226			
Adjusted R-squared	0.451445			
S.E. of regression	0.009279			
F-statistic	7.378017	Durbin-Watson stat		1.307614
Prob(F-statistic)	0.000001			

***, **, * indicate significant at 1%, 5%, and 10% significance level respectively.

This regression's adjusted R² is 0.45, meaning that 45% of the variation in the dependent variable (ROA) can be explained by the regressors in Model 2. The F- statistic for the regression is likewise significant at zero P-value to five decimal places. This shows there is still a good explanatory power of the regressors in the model. The regression results in Table 4.3 reveal that all the significant variables in the previous regression (Table 4.2) are still significant. Capital adequacy ratio, board size, as well as presence of audit committee are statistically significant at 5%; while the squares of capital adequacy ratio and bank size are statistically significant at 1%. However, there is no statistically significant impact of ownership type, loan loss provision, or loan to deposit ratio on performance. However, the coefficients of CAR, CAR2 and LLP have changed signs.

Discussion on Findings

The results of model 1 revealed that there is inverse relationship between CAR and ROE. This outcome is in accordance with the conclusions of [20], who contend that because of central bank control, the relationship between CAR and ROE may not be linear. To safeguard the interests of depositors, the central bank mandates that banks maintain a CAR level of at least 8%. Therefore, the negative impact of CAR on ROE will become positive when it surpasses the threshold at which depositors perceive and believe that the bank will be concerned with implementing good corporate governance. At that point, they will be interested in depositing their money and purchasing the bank's

shares, which will increase the bank's profitability. CAR2 was introduced to address this issue, and it has been discovered that CAR2 has a positive effect on ROE.

Performance is negatively impacted by board size, suggesting that banks with bigger boards often perform worse than banks with smaller boards. Although it runs counter to the results of [18] and [19], who discovered a positive correlation between board size and bank performance, this is consistent with the findings of [17], who discovered a negative association. Board size may have a negative impact on bank performance because boards with too many directors may be ineffective and their members may not communicate well with one another [24]. This leads to director free riding problem i.e. directors consume more resources than they contribute to the bank, and thereby reducing bank performance.

The presence of an audit committee (AUDC) has a negative impact on bank performance (ROE), indicating that banks with an audit committee on the board perform worse than those without. This finding runs counter to our theory that the audit committee had a beneficial impact on performance after [25]. Nevertheless, the negative effect of audit committee on bank performance could be attributed to the audit committee members' lack of expertise in helping the board in the governance of the bank, leading to mere increase in board size and board of directors' fee.

Bank performance (ROE) is positively impacted by bank size (BKSZ), suggesting that larger banks make more money than smaller ones. This benefit is consistent with the findings of [28] and is probably the result of economies of scale and the larger market share held by the larger banks.

Model 2's regression result indicates that CAR has a positive impact on ROA, indicating that a bank's external corporate governance enhances performance. This aligns with the expectations and is corroborated by the findings of [21] and [29]. Consistent to the results obtained from regression Model 1, board size has a negative effect on bank performance. Similarly, audit committee in the board (AUDC) is found to have a negative effect on bank performance. In line with the findings of model 1, bank size (BKSZ) has a positive impact on bank performance (ROA).

Ownership type (OWTP), loan loss provision (LLP) and loan to deposit ratio (LDR) are found to have no significant effect on bank performance. This suggests that bank profitability is not significantly impacted by the size of the loan loss provision, which is a gauge of management's risk-taking behavior. This might be because the income from loans made equals the amount of loss resulting from the risk of uncollectible loans. This contradicts the hypothesis that there is negative relationship between loan loss provision and bank performance. Likewise, in contrast to our theory, the size of the loan to deposit ratio has no discernible impact on bank performance, indicating that a bank's performance is unaffected by the source of funding (shareholders or depositors) used to make loans.

Furthermore, the bank's profitability is not substantially impacted by its ownership structure, whether it is state-owned or privately held. [30], who discovered a negligible difference in the performance of Ethiopia's state-owned and private banks, also supports this conclusion. The fact that the data did not support the broad belief that privately held enterprises in general do better as compared to state-owned ones.

This might be due to the fact that leadership, management and operation systems of the Ethiopian private banks are replications of the state-owned ones. In particular, practically every individual in higher, middle, and lower managerial positions in private banks was formerly employed by state-owned banks, which replicated their management systems and bureaucracy. Regarding the kind and caliber of services they offer, state and private banks are identical.

V. CONCLUSION

The outcome of the two regression models indicated consistent evidence. Bank performance and CAR, a measure of external corporate governance, are positively correlated, suggesting that improved corporate governance boosts bank performance. Because of government regulation, the impact of CAR on ROE is non-linear. Hence, the negative impact of CAR on ROE is projected to shift in to positive when CAR grows to a specific level where the financial soundness of the bank improves. Conversely, a bank's profitability is adversely impacted by the size of its board of directors, suggesting that a bank's profitability increases with the number of directors on the board.

Similarly, existence of audit committee in the board has bad influence on the profitability of the bank while the size of the bank is an essential element with a positive contribution to its profitability. Bank profitability is not affected by the proportion of loan loss provision. This seems to imply that managers who assume a greater risk of losing money as

a result of uncollectible loans receive an equal share of the proceeds from loans. Similarly, the extent of a bank's dependence on the depositors' cash to make loan has little influence on the banks profitability. Lastly, a bank's profitability will essentially be the same whether it is controlled by the government or private investors.

Policy Implications

Empirical findings reveal that as a means to strengthen the performance of commercial banks in Ethiopia, the government or National Bank of Ethiopia should be concerned about the level of both internal and external corporate governance mechanisms of banks. The results also indicate that in order to achieve higher and more sustainable profits, shareholders should actively participate in the establishment of sound corporate governance in the banks they own. The National Bank of Ethiopia should encourage banks to implement good corporate governance practices through enacting rules and regulations. Keeping the number of director in a bank board to a minimal size is suggested, so long as that minimum size allows the board to conduct its oversight activities correctly.

Commercial banks should increase their branches as well as their size in order to improve profitability due to economies of scale. The government, and financial institutions as well as the business community should strive towards the formation of a formal capital market institutions notably stock exchange which increases corporate governance, and competitiveness among enterprises in the nation. Lastly, evaluating corporate governance practices and firm performance from the viewpoints of various stakeholders, including staff, management, shareholders, and commercial bank depositors, should be the main focus of future research.

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