

Board Characteristics, Ownership Structure and Bank Performance: Evidence from Iraq

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Abstract: This paper presents the key role of corporate governance on the performance of banks in Iraq. This study aims to examine the relationship between board characteristics, ownership structure, and bank performance by considering panel data of 18 banks for period 2005-2021 in Iraq. This relationship is estimated by using the panel OLS and regression technique. The findings reveal there is a significant positive relationship between board composition, family ownership, board size and bank performance. Additionally, findings show that female board of directors is one of the reasons to make down the bank performance in Iraq. Taken together, this study finding recommended to regulators, in particular for the current financial reform of corporate boards.

Keywords: Bank performance, corporate governance, Panel data, Agency theory

Introduction

In the current era, corporate governance took more attention and interest in every organization. Corporate governance is more grown in the banking industry, especially the failure banks including Lehman Brothers bank, Merrill Lynch Bank, Northern Rock Bank, Freddie Mac Bank, Fannie Mae Bank, HPOS bank, Washington Mutual Bank and UBS bank in the US and Europe. There was a need to introduce strong corporate governance which verified country level and international level by different developments and standards such as US Sarbanes- Oxley Act 2000, UK Combined Code,

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Australia CLERP 9, and the Organization for Economic Development [OECD] Code.

The main purpose of corporate governance is to establish ownership structure and management structure for the confirmation of managers, whether managers are working for the benefits of shareholders or not. According to agency theory by Jensen and Meckling (1976), there is a conflict between the owner (principal) and management (agent) which create agency problem, this conflict can be related to extra consumption or make an investment in low-risk assets rather than focus on shareholder wealth maximization. Similarly, Fama and Jensen (1983) proposed that boards of director can reduce agency conflict by looking some decision and separate the management from that decisions. For example, US Sarbanes-Oxley Act presented to increase the transparency and reduce the agency cost by legislative listed firms' governance requirements.

There is the significant role of the board of directors by managers monitoring or controlling strategies decisions in the governance of banking industry (De Andres & Vallelado, 2008). Abdullah (2004) stated that the main function of the board is to take care of the shareholders' wealth. The responsibilities of the board of directors are developing business strategies, opined that the principal objective of a board is to keep the interests of stakeholders. They are responsible for organizing corporate objectives, developing strategic business plans, evaluating and monitoring the efficient implementation of business approaches and management activities (Nekhili & Gatfaoui, 2013; Wang & Hsu, 2013 and Abdullah, 2004).

The board operates under the mechanism of corporate governance to appoint, supervise, and remunerate the senior managers while monitoring the influence on firm's overall strategy (Campbell & Mínguez-Vera, 2008). In banks, the board has amore significant role as compared to non-financial institutions due to extended responsibilities of regulators and depositors along with stakeholders (Macey & O'Hara, 2003). Thus, the board of a bank plays a significant role in the execution of governance mechanism effectively (Kilic, 2015; Pathan *et al.*, 2013).

This paper is likely to expand research by its contribution towards a better understanding of the board characteristics, ownership structure and performance of banks in Iraq. The key focus of the study is in the composition of the board of directors, the size of the board, board gender, family ownership, institution ownership and insider ownership. In banks, these measures of corporate governance and ownership play a major role. Furthermore, this study uses Return on Equity (ROE) to measure bank performance. Moreover, it also identifies that corporate governance factors which influence the performance of banks in Iraq are similar to those in

western businesses. Since corporate governance was unable to attract the attention of researchers in Iraq, this study provides a better understanding of corporate governance and ownership structure with the performance of banks, similar to that of global markets.

2. Literature Review and Hypotheses Development

This segment includes the understanding of board characteristics, ownership structure, bank performance and hypothesis development. Board characteristics are explained along three dimensions of composition, size, and gender of the board. Likewise, ownership structure has three dimensions: family ownership, institution ownership, and insider ownership. Firstly, the association between the composition of board and performance of the bank is discussed. Next, the discussion includes the relationship of board size and gender, family ownership, institution ownership, and inside ownership with the performance of the bank.

2.1. Board Composition and Performance of Bank

Currently, the key issue faced by the management of the firms is the board of director's composition (Carter *et al.*, 2003). Therefore, it is of significance importance for researchers to examine the influence of the composition of the board on the performance of banks. Several studies have agreed that high ratio of outside directors establishes the effective board (Lorsch and MacIver (1989); Mizruchi (1983); Zahra and Pearce (1989)). Furthermore, Shungu *et al.* (2014), Bektas and Kaymak (2009) and Pathan *et al.* (2007) identifies a positive correlation between independence of board and performance of Thai and Turkish banks. However, Adams and Mehran (2008) and Stanèia *et al.* (2012) does not found any evidence of a correlation between board composition and performance of the bank. Firms with non-executive directors are independent, works in stakeholder's best interest, have better controlover management and have a positive influence on performance (Borokhovich *et al.*, 1996; Hermalin & Weisbach, 1988). Recently, the composition of the board has become a key area of interest among governments, researchers, academicians, and debates in public forums because of the benefits associated with the availability of diversified board members in the organizations Kilic (2015). Agency theory arguesthatoutside directors in the board hold the advantage of monitoring the management to keep their reputation as independent and efficient decision makers (Fama & Jensen, 1983). The statement supports that increase in non-executive directors reduces the agency problem, as non-executive directors tend to be more vigilant in overall management and enhance the performance of banks. Consequently, we empirically test the below hypothesis:

H1: There is a positive association between board composition and performance of the bank.

2.2. Board Size and Performance of Bank

Board size denotes the aggregated number of directors in a board who have the voting rights (Ongore *et al.*, 2015; Pugliese & Wenstop, 2007). Board of Directors represents the mechanism of internal governance which control the agency problems in any corporate system (Li *et al.* 2008; Cerbioni and Parbonetti 2007). Numerous scholars articulate board size and banks' performance as opposing ways. In the first place, some researchers argued that increase in the size of the board be directly related to rising in coordination and communication problems between the members of the board (Cerbioni & Parbonetti, 2007; Bushman *et al.*, 2004). Arguably, as the board size increases, monitoring capacity of directors also increase. This statement supported by Klein (2002), who emphasized on large board size as compared to the small size and was related to specialized advisory and monitoring management. Likewise, Lipton and Lorsch, (1992) recommend that increasing size of the board make it difficult for the organization to call upon regular meetings. Furthermore, the decision-making process of the large board is slow which affect their ability to capture the new business opportunities (Bantel & Jackson, 1989).

On the other hand, researchers proposed that boards with small size enhance the monitoring abilities of management (Khanchel, 2007; Yermack, 1996). They found that monitoring ability is negatively related to the size of the board. Studies have found different results when examined board size. Jensen (1993) support the small size of the board and found its positive correlation with performance. He also argued that when board size increase above seven or eight the efficiency of board decreases and CEO of the company lose control on the board. Similarly, Lipton and Lorsch, (1992) found that it becomes difficult for board members to express opinions and give ideas when some board members are above ten. Furthermore, overcrowded board results in job loss for employees, money loss for stakeholders and competitive market position for the corporation. In another scenario, a study by De Andres and Vallelado (2008) found that board size has inverted U-shaped correlation with performance, challenging the belief that efficiency increases with small board size. The study was based on commercial banks from U.S, U.K, Canada, Italy, France and Spain holding 69 boards for the year 1995-2005.

According to Agency theory, firms with the large size of the board usually have more value. The theory suggests that management of companies whose size of the board is large have less CEO domination,

have more efficient monitoring which increases the overall firm performance (Fitriya & Locke, 2012; Singh & Harianto, 1989).

Since the influence of the size of the board on the performance of the bank show inconsistent results. This study assumed that firms with the large board have a broad range of access to the resources and have effective management monitoring and expertise. Consequently, the study will empirically test the hypothesis below:

H2: There is a positive association between board size and bank performance.

2.3. Board gender and bank performance

Board diversity contributes better problem-solving capacity, creativity, and knowledge to manage banks. Carter *et al.* (2003) support the significance of diversity in a board because diversity provides new and multiple outlooks for solving any problem. Erhardt *et al.* (2003) and Ramly *et al.* (2015) also states that board diversity has a positive correlation with firm value and performance due to unique and diversified attributes associated with board members which are helpful for high-quality decisions.

Several benefits related to female board member includes educational background, communication style, personality, career expertise, and experiences. According to Liao *et al.*, (2015), female directors make a major and broader contribution in any decision-making. However, female members are usually less oriented towards power but are more concerned and compassionate than male board directors (Ramly *et al.*, 2015). Additionally, commitment and involvement level of women are high which enhance the process of decision making. Furthermore, they have less self-interest concern and are more hard working which increases effectiveness and performance of the corporates (Liao *et al.*, 2015; Lucas-Perez *et al.*, 2015). Additionally, the attendance for female board members is high as compared to male board members and diversity also increase the monitoring ability of the board (Adams & Ferreira 2009).

Concerning the association amongst gender variety and banks' performance, the scarce prevailing experiential finding indicates conflicting results. Ongore *et al.* (2015), Shungu *et al.* (2014), and Pathan *et al.* (2013) found a positive correlation amongst the proportion of women directors and banks' performance. Conversely, Kilic (2015) found an adverse correlation between gender diversity and bank performance. Meanwhile, Liang, Xu, & Jiraporn (2013) show no significant association amongst the proportion of women on the board of directors and banks' performance.

Agency theory opines that better monitoring of managers is linked with the diverse board because diversity enhances the independence of board (Carter *et al.*, 2007). Board independence provides enhanced monitoring

which has a positive correlation with the performance of the firm. Therefore, board diversity represented by gender diversity may improve the board mechanism of management monitoring and control and may also enhance board independence (Campbell & Minguez-Vera, 2008). Consequently, the hypothesis concerning board gender which is to be tested empirically is stated as:

H3: There is a positive association between board gender and bank performance.

2.4. Family Ownership and Bank Performance

Agency theory claim that family ownership reduces the agency problem in a way that family members are part of management and ownership thus working toward the enhancement of firm value (Bocatto *et al.*, 2010). Additionally, earlier researchers found a positive correlation of family ownership with performance (Arouri *et al.*, 2014; Ben Slama Zouari & Boulila Taktak, 2014 and Maury, 2006). The monitoring increases with the growth in relationships of the family, thus improving the performance of the firm. Moreover, the time horizon for founding managers from family is more than those apart from family and have the ability to minimize the uncertainty of control and ownership (Anderson & Reeb, 2003). Also, Moin (2011) argue that family ownership is harmful to the performance of the bank. The stakeholders of the family with considerable rights of cash flows may benefit their family with these opportunities, thus affecting the performance of the firm. Inconsistent results in the previous literature are found when examining the influence of family ownership on the performance of the bank. Consequently, the hypothesis concerning family ownership which is to be tested empirically is:

H4: There is a positive association between family ownership and bank performance.

2.5. Institution Ownership and Bank Performance

Previous empirical research on the correlation between institutional ownership and performance of bank have found mixed results. Arouri *et al.* (2014) found a positive relationship between institution ownership and performance of the bank in Gulf Cooperation Council countries excluding Kuwait. Similarly, Tomar and Bino (2012) have stated a positive correlation between institutional ownership and several performance measures of banks. Also, Elyasiani and Jia (2008) found a positive correlation among institution ownership and bank performance. To improve their equity investments values, Institutional investors usually tend to be active monitors (Chen *et al.*, 2007).

Institutional ownership is linked with high performance because it is expected that institutional ownership may reduce the agency problem among stakeholders and managers, lowers opportunities and incentives for control earnings, and improve performance effectiveness. Conversely, previous research stated that increased focus of institutional investors on short-term profit and liquidity of their investment outweighs the monitoring management benefits which affect performance in the long term (Bhide, 1994; Maug, 1998). Al-Amarneh (2014), Arouri *et al.* (2011) found no significant correlation between levels of institutional ownership and performance of banks. Consequently, the hypothesis concerning institution ownership to be tested empirically is stated thus:

H5: Institutional ownership positively influences the performance of the bank.

2.6. Insider Ownership and Bank Performance

Insider ownership aligns the interests of the management and shareholders. Agency theory stated that increase in manager's ownership reduces the agency problem as interests of stakeholders and managers get aligned, which enhance the performance of banks (Jensen and Meckling, 1976). However, previous scholars found mixed results when addressing same issues in different countries. Garcia-Cestona & Surroca (2008) examined the insider ownership structure in that Spanish savings banks. Results reveal that founders, depositors, and employees in insider ownership focus more on the maximization of profit and perform better than banks under Public administrations. Likewise, Westman (2011) also found a significant positive correlation between insider ownership and performance of the bank. Nonetheless, Kabigting (2011) found that higher insider ownership is often associated with worse performance. On the other hand, Aebi *et al.* (2012) found that insider ownership does not influence bank performance during the recent financial crisis. Thus, the effect of insider ownership on the performance of the bank is still questionable. Consequently, the hypothesis concerning insider ownership to be tested empirically is stated thus:

H6: Insider ownership positively influences the performance of the bank.

2.7. Other Variables

2.7.1 Bank Size

The bank size is linked with economies of scale and has a probability of improving the financial performance of the organizations. Similar to previous researchers, this study has employed bank size as a control variable (Jadah, Hameed, & Al-Husainy, 2020).

2.7.1. Non-Performing Loans (NPL)

According to Hu *et al.* (2004) controlling NPL is essential for the bank performance. Also, El-Chaarani (2014) and Zhang & Yang (2011) assert that NPL has been widely used to control the effects of corporate governance to bank performance, and have been found to be significant.

3. Research Method

This segment includes the employment of sample and sources of data and econometric model.

3.1. Data and Model Specification

To measure bank performance, this study use ROE, which defined as net income of the bank after deduction of tax by employing its total equity (Liang *et al.*, 2013). Board characteristics are in six dimensions: Board characteristics is in three dimensions: Board composition (BODC), board size (BODS) and board gender (BODG). Likewise, ownership structure in three dimensions: family ownership (FAMOWN), institution ownership (INSTOWN) and insider ownership (INSOWN). In line with the studies of Jadah, Murugiah, and Adzis (2016a). board composition (BODC) is calculated by the number of non-executive directors in bank's board. The size of the board is the representation of a total number of board directors (Fanta, Kemal, Waka, 2013). Board gender is the proportion of directors on board which is female (Jadah *et al.*, 2016; Liang *et al.*, 2013). Family ownership is calculated by dividing the shares of the family by total outstanding shares (Jadah, Murugiah, & Adzis, 2016b; Villalonga & Amit, 2006). Institution ownership is calculated by dividing institutional shares by total common outstanding shares (Victoravich *et al.*, 2012). Insider ownership is calculated by the proportion of equity ownership of managers to total common outstanding shares (Jadah *et al.*, 2016b; Kaserer & Moldenhauer, 2008). The bank size (BANKZ) is measured by taking the natural log of banks assets (Jadah *et al.*, 2020). Non-performing loans represent the ratio of loans which are not performing to total loans in each bank at year end (Zhang & Yang, 2011). As far as this work is concerned, a total sample of 24 commercial banks in Iraq was used. Data is obtained from annual financial reports of the 18 commercial banks in Iraq for the year 2005-2021. Total observations in the sample are 306.

The study used panel data tests to investigate the effect of characteristics of the board on the performance of banks. By using Panel data analysis, estimation biases can be reduced to the maximum extent, overcoming the issues of multicollinearity. This provides time-variant relationship while analyzing the correlation among independent and dependent (Baltagi, 2001). The proposed model for this study is:

4. Results and Discussions

In this section, the empirical examination of the influence of board characteristics and ownership structure on the performance of the bank is presented and discussed. Table 1 illustrates the panel tests to select the appropriate model, fixed effects, random effects or pooled OLS. The first test is Hausmann test to compare between random and fixed effects. For Hausmann test, when the p-value is lower than 0.05 that mean fixed effect is the more appropriate for the model. The second criterion is FE test to compare between fixed effects and pooled OLS. The p-value for FE test is higher than 0.05 that mean pooled OLS is the more appropriate model.

Table 1: Board characteristics, Ownership structure and bank performance (ROE)

<i>Variable</i>	<i>Coefficient</i>	<i>t-Statistic</i>	<i>Prob.</i>
Constant	0.181	1.206	0.229
BODC	0.145**	4.495	0.000
BODS	0.0223**	4.8902	0.0000
BODG	-0.1843**	-2.7794	0.0058
FAMOWN	0.1061*	2.1934	0.0290
INSTOWN	-0.0059	-0.1642	0.8696
INSOWN	0.1061**	2.1934	0.0290
BANKZ	0.0374*	2.0179	0.0445
NPL	-0.6421**	-6.3594	0.0000
R-squared	0.2993		
Adjusted R-squared	0.2812		
F-statistic	16.606		
Prob(F-statistic)	0.0000		
<i>Diagnostic Tests</i>	<i>P-value</i>	<i>Results</i>	
Hausman Test	0.0003	Fixed Effects	
FE Test	0.3459	Pooled OLS	
Normality	0.2036	The residual normally distributed	
Serial Correlation	0.1866	There is no serial correlation problem	
Heteroscedasticity	0.0764	The residuals are homosceasticity	

Note: *and ** indicates significance at the 5% and 1% level respectively.

The regression result is shown in table 1. The regression equation employed ROE as its dependent variable and board composition, board size, and board gender as independent variables. Bank size and non-performing loan are control variables. Diagnostic tests: normality test, serial correlation test, and heteroscedasticity test were used in analyzing the estimated model. It is also found from Table 1 that BODC, BODS, BODG, FAMOWN, INSOWN, BANKZ and NPL are significant in explaining variations in ROE, but INSTOWN is insignificant to explaining variation in ROE. Nevertheless, not all the significant variables are found to meet the

expected sign or support the hypotheses. The positive sign of the coefficient of BODC, BODS, FAMOWN, INSOWN and BANKZ indicate that an increase in BODC, BODS, FAMOWN, INSOWN and BANKZ by one unit will increase ROE by 0.1596 units, 0.0241 units, 0.1061 units, 0.1061 units and 0.0333 units respectively. While, the negative sign of the coefficient of BODG and NPL indicates that, an increase in BODG and NPL by one unit will decrease ROE by 0.1046 units and 0.6558 units respectively. Table 1 illustrates also, normality test, serial correlation test, and heteroscedasticity test. The p-value in all tests are insignificant ($P > 0.05$), that mean the residual normally distributed and there is no autocorrelation and heteroscedasticity issues in the model.

Table 1 demonstrates that Board composition (ratio of non-executive directors) has a positive correlation with the performance of banks, implying that an increase in the non-executive directors of a bank increase its performance. These results support agency theory, which claims that the board with a high percentage of outside director results in better firm performance. Additionally, this finding is consistent with Jadah *et al.* (2016a); El-Chaarani (2014); Shungu *et al.* (2014); Zhang & Yang (2011); Bektas and Kaymak (2009) and Pathan *et al.* (2007) findings. Based on the results, the hypotheses of a significant positive relationship between board gender and performance of the bank is supported.

Table 1 illustrates that performance of bank and size of the board has a positive correlation. Furthermore, it improves the performance of the bank. These results support agency theory, which claims that the board with large size results in better firm performance. Additionally, this finding is consistent with Jadah *et al.* (2016a); Nodeh (2016); Stepanova and Ivantsova (2012); Adams and Mehran (2012); Belkhir (2009). Based on the results, the hypotheses of a significant positive relationship between board size and performance of the bank is supported. Furthermore, De Andres and Vallelado (2008) and Klein (2002) emphasized that large board size improve the advisory and have effective monitoring of the management as compared to the small size. Thus, banks in Iraq with a large number of board directors have the advantage of more efficiency and accountability of their operations.

In general, firms having a large number of female board members have the benefit of pooling a better human capital which provides better directors with different perspectives having additional skills as compared with firms having all male directors. Nonetheless, agency theory and relationship of female directors with the performance of bank are inverse to each other. Since agency theory supports the diversity which is helpful in reducing decision dominations and providing diversified viewpoints. Findings of the current study are similar to Kilic, 2015 for banks in Turkey but the

opposite of Pathan *et al.* (2013) for banks in the USA. As far as this study is a concern, the result rejects the testable hypothesis (H3). This implies that banks in Iraq do not found a significant correlation of female member of the board with the performance of banks.

Results illustrate a significant positive correlation of family ownership with performance (ROE) of the bank, showing that banks which have high family ownership perform better. The current study findings are aligned with Jadah *et al.* (2016b); Arouri *et al.*, 2014; Ben Slama Zouari & Boulila Taktak, 2014 and Maury, 2006) Additionally, in Iraq, bank ownership influence its performance which indicates a lower agency problem.

Negative insignificant correlation among the institution ownership and bank performance were illustrated by the results. Findings were similar to Arouri *et al.* (2011) and Al-Amarnah (2014). This is a bit surprising because investors in the institution are more experienced and can utilize the financial resources more efficiently to improve governance. Furthermore, they can minimize the agency problem and strive for maximizing the value of their personal investments in the equity of the banks, which should translate into superior bank performance. The results imply that institution ownership does not explain changes in performance of institution-owned banks in Iraq during the study period.

The findings of the current study show that there is a significant positive association between insider ownership (INSOWN) and performance of the bank. It supports agency theory, which argues the existence of convergence in the interest of managers and stakeholders as the ownership of managers increases. Thus, insider ownership minimizes the agency cost and enhances the performance of the bank (Jensen & Meckling, 1976). The current study has findings similar to Jadah *et al.* (2016b); Westman (2011) and Garcia-Cestona & Surroca (2008). In Iraq, ownership nature may be the cause. The increase in insider level of ownership decrease the agency cost and enhance the performance of banks.

Moreover, findings show that size of the bank has a positive influence on bank performance, which is according to the notion that large bank tends to have the ability for efficiency improvement through resource consolidation and alliance with other banks (Arouri, 2011). Nonetheless, the percentage of non-performing loan has a significant negative influence on performance as measured by ROE, which is according to the notion that non-performing loan in the financial sector increases the possibility to lead establishment to difficulty and worse bank performance (Messai & Jouini, 2013).

The overall findings depict that practices of governance in Iraq banks are good, including board characteristics (the number of directors,

composition, and gender of the board), and ownership structure (family ownership, insider ownership). These variables are significantly linked with bank' performance across financial measure ROE.

6. Conclusion and Recommendation

The study empirically examined the influence of board characteristics and ownership structure on bank financial performance. In previous research, researchers have emphasized on the relationship of board characteristics, ownership structure, and bank performance in developed and developing countries. This study is among few other studies which empirically examined the correlation between board characteristics and ownership structures with the bank financial performance in Iraq.

The analysis carried out in the scope of this paper allowed us to advance in the understanding of the impacts of board characteristics and ownership structure on financial performance, by empirically examining commercial banks in Iraq. In general, the findings provide evidence that board composition has a positive correlation with the performance of commercial banks in Iraq. While examining the board size, this study found that large board size has effective monitoring of the management as compared to the small size. Thus, banks in Iraq with a large number of board directors have the advantage of more efficiency and accountability of their operations and positively improve the performance of banks. As for board gender, the findings suggest that the gender diversity of the board members worsen the performance of banks in Iraq. However, for family ownership, the findings show that family ownership has a positive correlation with the performance of the bank in Iraq. Finally, an insider has a positive association with performance regarding ROE for banks in Iraq. The paper, therefore, recommends that banks committed toward the enhancement of performance should establish more non-executive directors, big-sized boards of directors, a high percentage of family ownership, a large percentage of insider ownership, composed of few female directors in the board.

Moreover, the results of this paper provide a bridge for future research. For any potential researchers need to replicate and reinvestigate the argument introduced here in other contexts. Second, examining how the board characteristics, ownership structure, and financial performance varies with a bank's life cycle is likely to be considered for future research. It is important as corporate governance parameters may be related to strategic thresholds in the life cycle of banks. Third, future research is encouraged to empirically examine the moderating or mediating impact among the structure of ownership, board characteristics, and financial performance. Lastly, to keep the balanced skills in the boardroom, Iraqi banks may require

larger boards with a high percentage of non-executive directors by incorporating more male directors in their operations.

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