IOSR Journal of Business and Management (IOSR-JBM)
e-ISSN: 2278-487X, p-ISSN: 2319-7668. Volume 17, Issue 3.Ver. III (Mar. 2015), PP 56-71
www.iosrjournals.org

The Impact of Corporate Governance on Financial Performance of Banks Evidence from Pakistan

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Abstract:*The study investigates role of corporate governance on bank performance in the Pakistani Context. Governance parameters include board size, board independence, ownership concentration and CEO duality. A regression model using ROA and ROE as a measures of performance, is attempted. The data corresponds to a panel of 19, listed Pakistani banks for the period 2005–2010.The regression analysis shows that Governance variables have impact on performance variables. The results provide support for the proposed model, and suggest the need for further research into framework for governance and Bank performance. The data corresponds to the 19 Pakistani Banks for the period of 2005 to 2010.*

Keywords: Corporate Governance**,** Ownership Concentration, Board Independence, Board Size.

I. Introduction

Some of the important collapses and failures in the current memories about the financial sector showthe importance of corporate governance mechanism in controlling and maintaining the investor's interest. There are many crucial examples of risks that occur due to corporate governance failure in organizations like Enron, Parmalat and others since 2001.Loss of billions of dollars of investor's capital in the recent financial crisis of US in 2008 proved that current checks and balancescan not safeguard the owner of the firms from the misuse of company's property and the misplaced priorities of board members

Many countries and industry groups had formed new corporate governance code in reaction of current corporate governance failures on worldwide markets. These codes set a right value and also help in finding internal controls that aim at the investor's interest. Whereas government mandates and these controlled industry codes will surely help the investors self assurance in the markets. Investors also have to plan to assess the occurrence and non existence of corporate governance safeguard of companies in which they make investment and also their corporate customs.

State Bank of Pakistan has also emphasized that there should be corporate governance at every banking organization. Managerial information around the world underscores the need of having the suitable level of responsibility and checks and balances within each bank to provide a common and effective affiliation between bank management and bank and bank controller. Strong corporate governance in the organization makes the work of management somewhat easier. Corporate governance makes banking institutions safe, sound and efficient and, therefore increases confidence of depositors in the banking system.

1.1 Statement of Problem

Measuring financial performance is the easy part, but, corporate governance to an immense level is a qualitative phenomenon. So the real problem is "how to measure the quality of corporate governance in banks and how to identify the characteristics of the banks with good governance?"

1.2 Research Questions

This research is conducted to find out the answer of the following question.

- Does corporate governance affect banks performance? If yes then; how is corporate governance to be measured?

1.3 Purpose of Study

The purpose of this studyis to highlight the importance of adoption of good corporate governance and to assist bankers, auditors and public at large to understand the importance of corporate governance.

1.4 Objective of Study

The objective of this study is to inspect the impact of corporate governance on the financial performance of commercial banks in Pakistan and to explore the fact that following good corporate governance practices' (i.e. being fair to all stakeholders) actually leads to better financial performance, thereby best serving the interest of shareholders. This study therefore aims at establishing empirical evidence of therelationshipbetweenthe value of corporate governance and financial performance of banks in Pakistan.

1.5 Significance of Study

In order to work effectively and efficiently, shareholdersshould be dynamic and careful for the use of their rights. This means thatshareholders should practice their rights and act like owners of the firm. A number of studies published in the last few years haverevealed a positive connection between corporate governance and performance measures.

One would predict to compensate the firmsusing better governance with high valuation. The study of Paul Gompers (2003) reveals that the portfolios of companies providing shareholder rights perform in a better position as compared to those companies with portfolios providing weaker protection to shareowners by 8.5% per year. The related study was conducted in German market from March 1998 to February 2002 and found that the portfolio of best governed companies do better than a portfolio of the worst governed companies by the average of 2.33% per month.

This fact is not new and restricted to developed markets. Analyst in Malaysia practiced higher returns in companies adopting good governance system. About 8 of the 100 biggest companies having the preeminent governance consist of managementregulations, simplicity,self-determination, accountability, justice and social conscientiousnesscausing five year returns to be above average.

The countries that require financing must be strong in corporate governance system. The reason behind Pakistan's failure to get financing is because of the weak corporate governance system and weak investor's protection. So in order to face challenges, to increase integration, deregulation and technological development require the review of corporate governance system.

So we can conclude that best corporate governance produce improved results for the companies and for the investors in both the developed and developing countries. Moreover corporate governance is an issue that cannot be ignored and investors can use it for their own betterment and also for the benefits of their clients.

II. Literature Review

2.1 Definition of Corporate Governance

Corporate governance definition changes from country to country. In European countries like Germany the word corporate governance means all shareholders of a company while in Anglo American countries corporate governance refers to fair returns for depositor (Goergen, Manjon and Renneboog, 2005). The corporate governance is used to ensure the effectiveness and efficiency among executive remuneration contracts, shareholder monitoring, dividend strategy and the regulatory system of the corporate law and the stock exchanges.

Corporate governance is an arrangement of internal controls and measures by which companies are administered. It provides a structure that defines roles and responsibilities of board, shareholders, management within the organization. This method is significant for those companies having dispersed minority shareholders. In order to minimize the conflict between insiders and external shareholders corporate governance plays an important role through the better arrangement of checks and balances. Its main function is the cash flows and asset.

Shleifer and Vishny (1997) define corporate governance by emphasizing that it "deals with the customs in which suppliers of finance to corporations pledge themselves of getting a return on their investment (p.737)". According to CaramanolisCötelli(1995)corporate governance can be defined as fair and equal distribution between insiders and also executives, directors, individuals or CEO's and the management.

Hart (1995) suggests that "corporate governance issues occur in an organization when two conditions are there. First, there is an agency problem, or clash of interest, involving members of the organization – these may be owners, managers, personnel or customers. Second, transaction costs are such that this agency problem cannot dealduring a contract (p. 678)".

In a broad sense, good corporate governance makes sure that:

- Board members take measures in the interest of shareholders.
- The company should act in a officially recognized and in a proper way in transactions with all shareholders and their legislative body
- The board and its committeewillperformseparately from management and individuals that have control over management.
- Proper control and measures should be taken in organizing dailyactivities of the company
- The company should report to shareholders its operating and financial activities ina reasonable, exact, timely, consistent, appropriate complete and supportable manner.

How effectively and efficiently companies achieve these goals depend on the extent of the company corporate governance arrangements and power of shareholders in corporate governance matters. The achievement of the board in protecting shareowner interest depends on the above mentioned factors.

2.2 Corporate Governance of Banks

The corporate governance in banking sector has been increasing in current years, because of the continued high growth of debt financing of the economy,transformation in many countries, and the responsibility of banks in ensuring financial strength. In Pakistan, considerable changes occurred in the banking sector in the last decade like privatization of banks except National Bank of Pakistan (NBP), liberalization of financial system and appearance of new private banks. As a result, the ownership structure of some banks and the full banking structurehavealtered.

Banks are a significantpart of an economy. They are the custodian of public money and make available, financing for profit-making enterprises, essentialmonetary services to the large number of the populations and access to payment system. Banks also provide credit facility and also take steps to cope up with the irregularity of information.Banks are identical to other firms in terms of the work of shareholders, debt holders, board of directors, competitors, etc.

Bank and payment system are the major part of the financial system. Transactions of banks compriseof different types of risk. Good corporate governance helps the bank to work without any risk factor and to attain strong financial system. On the other hand the strength of financial system is also based on awell-organized, consistent and fast payment system. This shows that payment system of banks consist of different types of risk. This risk can be eliminated by ensuring the proper method for dealing with the payments; by maintaining reserves and through the strong governance system. Breakdown in the system of paymentcan createserious disturbances to the financial system and possibly have negative influence on the monetary system as well as to the economy(Bollard, 2003).

So it is significant that management and payment system workersrecognize, observe and manage the possibilityof risk and good corporate governance will assist them to accomplishthese objectives.

2.3 Corporate Governance of Banks In Pakistan

In 1990s Pakistanadopted the financial deregulation strategy to strengthen itsfinancial sector. These improvements include free from the regulation of interest rates, terms and condition for private and foreign banks, growth of money and capital markets, privatization and denationalization of banks. A motivating and significant characteristic of this improvement was the restructuring and reorganization of the central bank, the State Bank of Pakistan (SBP). As a result the SBP has come into view as aself-governing and competent central bank. SBP take measures to make commercial banks more efficient and producesecuresurroundings for them. To attain these objectives SBP make a controllingstructure to operate the commercial banking industry and issuerules for corporate governance.

With the help of independent and accountable central bank, Accountability Bureau, Pakistan has made significant progress in recovering a large portion of defaulted loans. The restructure of regulations also limit the provision and extension of credit facilities to those whose financial position is not stable. With the control of inflation interest rates are more stable which leads to the increase in deposits. However, in order to avoid any banking crisis, there must be skilled and efficient management. In order to strengthen the financial stability of banks, State Bank of Pakistan in 2002introduced guidelines for corporate governance for banks i.e. code of corporate governance. This code of corporate governance is helpful in crating stakeholders' awareness, capacity building and networking with the emerging economies. In order to cope up with the problems of banking sector State Bank of Pakistan also issued a handbook of corporate governance which provide guidelines for board of directors, managers and shareholders.

2.4 Corporate Governance and Performance

An empirical study in corporate governance pays attention on the relation between corporate governance and bank performance. Areas highlighted in corporate governance of a firm are its ownership structure and board effectiveness. Board effectiveness variable considered in various studies include board size, board independence, and CEO duality. The literature on ownership has been examined in detail in the subsequent sections of the chapter. Following are the some of the important determinant of corporate governance.

- Board of Directors
- Institutional Shareholders
- Insider Holdings
- Board Independence
- Board Size

- CEO Duality
- Ownership Concentration

In this study only four parameters of corporate governance are selected because of the availability of the data. These variables include

- Board Independence
- Board Size
- CEO Duality
- Ownership Concentration

2.4.1Board Size

In literature there is mixed evidence about corporate performance and board size.Some researchers like Dalton et al., (1998); Pearce and Zahra, (1992),findpositive relationship between board size and firm performance. Some researchersare of the view that larger board is a symbol of community or grouphaving different environment and settingthat bring information and understanding to the board and therefore improves the quality of decision. Board size is also considered as change in the organization. This shows that smaller boards are unable to take initiative for the strategic change and need clear understanding of alternatives (Goilden&Zajac, 2001). On the other hand larger board consists of outsiders who are capable of making successful policy of decision making in firms.

Dalton et al. (1999) performed a meta-analysis of 131 observations (N = 20,620) across 27 studies on the relationship between board size and corporate governance. Return on asset and return on equity was used to measure the performance of the firm. The result of this analysis shows that there is positive relationship between the two variables that is larger board is associated with better performance.

Others suggest that larger board is less effective as compared to smaller boards. Because a larger board faces the problem of distribution of responsibilities whereas individual member of the board reduces the probability that other will find out their poor contributions. Moreover due to problems of coordination and contribution, larger board makes it difficult to utilize their skills, information and knowledge efficiently and effectively. As a result the board becomes more representative and isnot as much involved in management process.(Hermalin&Weisbach, 2001). Many researcherslike Goodstein et al., (1994)Yermack, (1996) Eisenberg et al., (1998) Van-EesandPostma, (2002), support this point of view and find a negative relationship between board size and corporate performance.

Eisenberg et al. (1998) studied 879 small firms in terms of sale, total asset and number of employees during 1992-1994 and find that larger board size,more than 6 to 7 persons, will lead to lower firm performance. They argue that larger board has coordination and communication problem which create hurdles in effective decision making and control of management. Moreover larger board consists of outsiders so they hesitate to take high risk projects due to their reputation, Yermack (1996).

2.4.2CEO Duality

In most of the U.S. companies CEO is also the chairman of the board (Brickley Coles and Jarrell, 1997). CEO or chair duality focuses power in the CEO’s position which allow for the more management decision. The double structure of office also allows the CEO to effectively and efficiently control the information assessable to other members of the board and therefore hinder the effective monitoring (Jensen, 1993). As a result if CEO duality obstructs the effective monitoring then it will lead to the greater use of unrestricted growth.

Many corporate practices suggest that role of board chairman and the CEO should be separated. Regulators of corporate governance identify CEO dominance over the board, as a source of excessive power (Dedman, 2000).The role of board is to supervise the CEO (Jensen, 1993). Chairman of the board has the authority to manage the schedule and meetings of board. If the CEO is also a chairman of the board then there are chances that autonomy of management and board are eliminated.

CEOpower becomesa problem if the concerns of CEO are different from the interest of the shareholders. Yermack (1996), Rechner and Dalton (1991) showsthat the firms havingself governingchairman do better with CEOauthority. CEOcontroldoes not essentially decline performancebut it also has an impact on the market level of controlimplemented on management performance and the financial reporting practices.

Pi and Timme (1993) finds that cost efficiency and return on assets diminishes when CEO and the Chairman are same.Rechner and Dalton (1991) are of the view that if CEO and chairman are same then firms underperform as compared to those with the separate positions.

Baliga, Moyer and Rao (1996), examine the long term performance of Fortune 500 firms and come to know that the announcement effects on firms that change from CEO being the Chair to split positions.

2.4.3Ownership Concentration

Ownership concentration determinesthe presence of large number of shareholders in a firm.Large shareholders havean opportunitytosupervise management. The reason is that the costrelatedto supervisingthe management isnot as muchas the anticipatedadvantages to large shareholders in the firm.Demsetz and Lehn (1985) and Stiglitz (1985) also find that large shareholders have an opportunity to accept the fixed cost of gatheringinformation and to monitoradministration.

On the other hand, dispersed ownership provides weak incentives to supervise the management (Maher and Anderson, 2000). In a casewhenshareholdershavefewer sharesin the firm,a shareholder has less or no opportunity to supervise the management (Ramsay and Blair, 1993; Hart, 1995). The reason is that the cost of monitoring managers will be high as compared to the gains.

Efficient and effective corporate governance is important for every country because it has direct impact on economic development of the country. So for effective decision making corporate governance system is important. The idea of corporate governance covers a great number of different economic relations. One of such relation is corporate ownership structure and its influence on performance.

Generally ownership structure is amechanism for minimizing the costs related tothe partition of ownership and management, which is used to protect property rights of the firm (Barbosa and Louri, 2002). Due to the progress in corporate governance many organizations possess dispersed ownership system and are controlled by appointed managers. According to Berle and Means (1932) those firms can not perform well whose owners are dispersed. Jensen and Meckling (1976), Shleifer and Vishny (1986) also support this statement.

The large shareholders are in a position and have an opportunity to maximize the value of shareholders (Jensen and Meckling, 1976; Zeckhouser and Pound, 1990; Burkart, 1997). Claessen*et al.* (1996 and 1999) find a positive relationship between ownership concentration and firm performance.

On the one hand, firm performance can be improved by merging the ownership and managerial interest through ownership concentration. (Agrawal and Mandelke (1987), Castianas and Helfat (1991), Weiner (1992)). In a case when a firm has large shareholders control cannot be disputed and as a result concentrated ownership may be low or entirely remove the agency cost. (Anderson et. al (1997). In contrast, blockholder ownership might provideachance to extort corporate resources for private benefits that have a negative influence on firm performance (Denis and McConnell (2003).

Demsetz (1983) found that ownership structure is a result of shareholders' decision. In order to take advantage ofthe value of a firm concentrated ownership may be required. The buying and selling of shares shows the desire of existing and possible owners tochange their stakes. Many papers consider the endogeneity of ownership to find out the impact ownership structure on firm performance.Demsetzet al. (2001) used a simultaneous equation and find insignificant relationship between ownership and performance. On the other hand Kole (1994) finds that performance affectownership rather than ownership affecting performance.

2.4.4 Board Independence

The board of directors is the shareholdersprimaryline of protection aligned with the management opportunisticperformance (Weisbach1988, Sundaramurthy2000). Board of directors hasthree mainduties in an organization (Lawler et al., 2002; Kenton, 1995). Firstly, board of directors isliablefor the planneddirection of the firm (kenser and johnson, 1990; Lorschand MacIver, 1989). Second, they givesuggestionsand asupportforsystem in the corporate society (Westphal, 1999; Lorsch and MacIver, 1989). Thirdly, they supervise the executive management in the interest ofshareholders (Johnson et al., 1996; Bainbridge, 1993; Fama, 1980). It's the thirdduty that has a direct influence on shareholders awareness of the firm's financial reporting reliability.

Board of directors supervise management and make sure that executive managers should perform their duties in the interest of shareholders (Fama and Jensen 1983). But all the boards do not supervise the corporate management (Sundaramurthy, 2000).

While Fama (1980) shows that internal board of directors have a problem of selfmonitoring and mostlyfragilesupervisingon executive officer, Lawler et al (2002) also presentfacts that board independence is asignificantaspect in encouraging the monitoring purposeof the board. The Tsui et al. (2001) also agrees that organizations with independent boards provide a successful monitoring system.

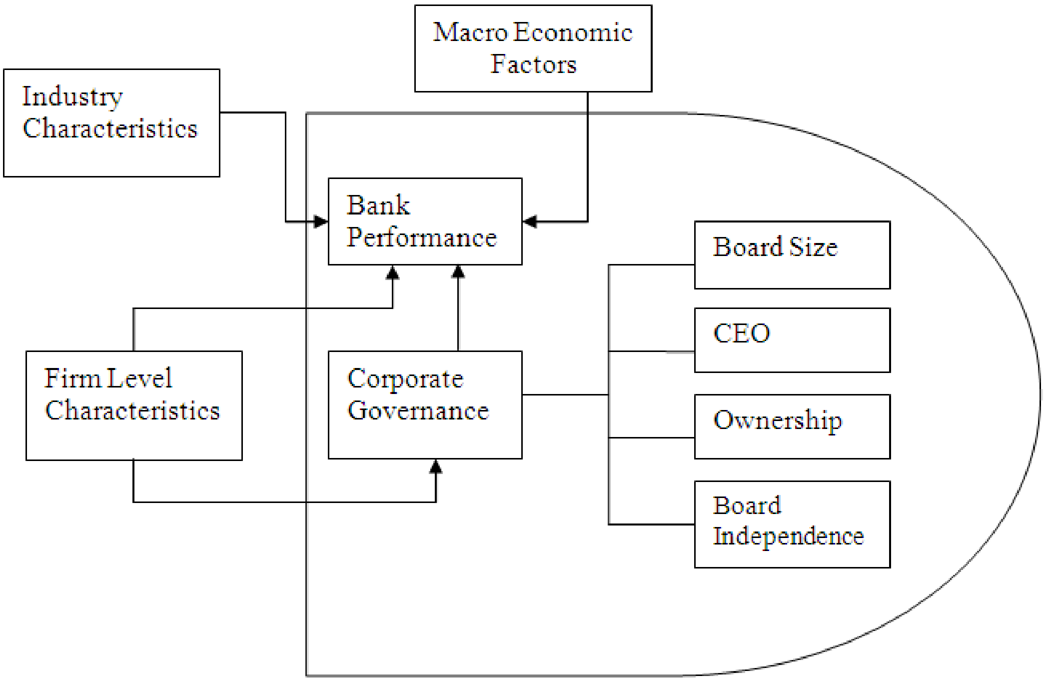
However, Klein et al.(2004), Subrahmanyamet al. (1997), and Agrawal and Knoeber (1996) find negative relationship between board independence and performance. This relationship is also supported by Weir and Laing (1999) and Yermacere exit k (1996).Haniffa and Hudaib (2006), Klein (1998), and Hermalin and Weishbach (1991) also suggest that ROA shows insignificant relationship between outside board of directors and performance.

III. Theoretical Framework And Methodology

In this chapter theoretical framework and the methodology used for testing of the model are discussed. Figure 1 shows the model of the study.

3.1 Theoretical Framework

Figure 1: Corporate Governance and Bank Performance



This figure shows that bank performance is affected by thefollowing variables;

- Macro EconomicVariables
- Industry Characteristics
- Firm Level Characteristics
- Corporate Governance

Macro economic factor consist of GNP growth. Whereas industry characteristics consistof industry growth and corporate governance variables include Board Size, CEO Duality, Ownership Concentration and Board Independence and firm level characteristics include the size of the bank etc.

3.2 Empirical Model

Performance Measures = F (Corporate Governance variables, GNP growth, Industry Growth)

1. ROA = $\beta 0 + \beta 1$ (BS) + $\beta 2$ (BI) + $\beta 3$ (OC) + $\beta 4$ (CEODU) + $\beta 5$(GNP) + $\beta 6$ (IND) + u

2. ROE = $\beta 0 + \beta 1$ (BS) + $\beta 2$ (BI) + $\beta 3$ (OC) + $\beta 4$ (CEODU) + $\beta 5$(GNP) + $\beta 6$ (IND) + u

Where;
ROA= Return on Asset
ROE= Return on Equity
BI= Board Independence
BS= Board Size
OC= Ownership Concentration
CEODU= CEO Duality
GNP= Gross National Product
IND= Industry Growth

3.3 Hypothesis Development

Ho: There is no relationship between corporate governance in banks and its

Financial performance

H1: There is a positive relationship between corporate governance in banks and its
Financial performanceor alternatively

"Banks with good governance practices will have better financial performance."

3.4 Variable of Study

3.4.1 Independent variables

Independent variables of this study are selected by keeping in mind the availability of data in the context of Pakistan. These are as follows;

1. Macro Economic Variable i.e. GNP Growth
2. Industry Specific (industry growth i.e. banking growth)
3. Corporate governance

Two measures of corporate governance variable are taken in this study. First, the four main components of corporate governance includes;

a. Size of Board
b. Duality of CEO
c. Independence of Board
d. Ownership Concentration

These are measured individually and included in the regression analysis and second, an index of the four components given above is constructed and included in the model representing corporate governance.

3.4.2 Measurement of Variables

Variables are measured as follows;

3.4.2.1Board Size and Corporate Governance

Following previous studies (e.g. Vafeas, 2000; Beasley, 1996), Board Size is calculated as the total number of directors on the board. The model of this study assumes that corporate governance is affected by Board Size i.e. a board of directors is a group of people selected by the shareholders of a company to manage the corporation. It is whether a large number of members are participating in the management or fewer people.

The literature also supports that there exist positive relationship between board size and financial performance.Dalton et al. (1999) conduct a meta-analysis of 131 observations (N = 20,620) across 27 studies on the relationship between the board size and financial performance. Dalton, Johnson, and Ell Strand (1999) find a positive and significant relationship between board size and performance of the firm.

3.4.2.2 CEO Duality and Corporate Governance

Following previous studies, **CEO Duality** is represented bya dummy variable that is, one if chairman of the board is not an independent director and zero otherwise.The relationship between the CEO duality and corporate governance is also shown i.e. the holding of both the top offices of the CEO and chairman by the same person can affect corporate governance which would have impact on to firm's performance.

3.4.2.3 Board independence and Corporate Governance

BoardIndependence is measured by number of independent directors divided by the total number of directors on the board. The impact on another variable that would be seen on corporate governance is board independence. The percentage of independent directors on the board is used to calculate the board independence. The literature also supports the proposition that presence of more independent directors on the board leads to better corporate governance, which in turn would positively impact the firm's performance.

3.4.2.4 Ownership Concentration and Corporate Governance

Following previous study (e.g. Ramsay and Blair, 1993; Crough 1980) percentage of holdings by top twenty shareholders is used to measure the Ownership Concentration that is percentage of total shares held by top 20 shareholders divided by total number of shares.

The relationship between the ownership concentration and corporate governance has also been shown. There is ample evidence in the literature, that the more the ownership concentration the less would be the effective corporate governance.

3.4.2.5 GNP

It is the aggregate money value of all the final goods and services produced in a country in a year plus income earned by its citizen (including income of those located abroad), minus income of non- residents located in that country. In order to calculate the money value of the goods, only final goods are taken into account. Basically GNP measures the value of goods and services that the country's citizen produced regardless of their location. GNP is the measure of the economic condition of a country, under the assumption that a higher GNP leads to higher quality of living; all others things being equal. Growth in GNP is expected to have a positive influence on the performance of banks.

In this study we have taken the value of GNP from the State Bank of Pakistan.

3.4.2.6 Industry Growth

Industry growth means that a sector of the economy having growth rate higher then average. If the companies in an industry show higher earnings and revenues this shows that it is in growth stage.Sometimes growing industries consist of volatile and risky stocks. Sometimes investors prefer increased risk in order to get larger gains offered by stocks within a particular growth industry.

Growth rate shows the increase that a specific variable has gained within specificperiod. For the investors, this represents the compounded annualized rate of growth of banks revenues, earnings, dividends and even macro concepts, such as economy as whole.

In this study industry growth is represented by banking growth. It is calculated by subtracting the previous year bank growth from current year bank growth then divides it by last year growth or percentage change in growth of a banking sector.

3.4.3 Dependent Variables

The dependent variables of this study are used to check the financial performance of banks. These will allow investigating the effects of differences in Governance characteristics on the financial performance.

Performance Measures

We have taken three measures of performance. The first two ROA, ROE are accounting based measures whereas market value added is market based measure.

a. Return on Asset (ROA)
b. Return on Equity (ROE)

Return on Assets

Return on asset is a performance measure and it shows that howgainful a firm iscomparatively to total assets. ROA determine that how efficiently and effectively company is managing its assets. Sometimes it is also known as "return on investment" and shown in percentage.On the other hand, some investors in order to use operating returns before cost of borrowing add interest expense back into net income.It is calculated as;

$$\text{Return on Asset} = \frac{\text{Net Profit}}{\text{Total Asset}}$$

Return on Equity

Financial performance is measured by the ROE (net profit / equity in book value).This is a very widely used measure. This measure is important for shareholders. ROE does not allowestimationof profitability of all invested funds. Furthermore, we should becareful to reprocess the absurd values Eric Severin (2001). This ratio is used to know that with respect to shareholders equity how many times the company earned.

$$\text{Return on Equity} = \frac{\text{Net Profit}}{\text{Total Equity}}$$

3.5 Sample and Data

3.5.1 Data

Annual reports of banks from the year 2005-2010 and the website of State bank of Pakistan i.e. www.sbp.org.pk are used to collect the data.

3.5.2 Sample

The sample was chosen from commercial Banks of Pakistan for the year of 2005-2010. From 40 commercial banks I have selected 19 banks because these banks were common in all years. The list of banks isattached in Annexure 1.

3.6 Analysis
3.6.1 Regression Analysis

Statistical methods used areestimated Least Square and Pooled Least Square regression analysis, to measure the relationship of two variable or we predict the value of dependent variable on the basis of independent variable. Method of measuring relationship between two variables is through the variation of dependent variable due to variation in independent variable. Regression result can not find the cause and effect relationship of variables without the support of theory regarding that issue (Keller &Warrack, 2003).

In this study initially we used the ordinary least square method (OLS) but because of presence of hetroscadasticity[1] we then used the generalized least square method. The results of panel EGLS were found to be appropriate as compared to the OLS method of estimation. In case of hetroscadasticity it is the GLS not the OLS that is BLUE (Best Linear Unbiased Estimator). OLS method shows the variability and doesn't make use of the information contained in the unequal variability of dependent variable. But GLS method takes such information into account explicitly and therefore capable of producing estimators that are BLUE.

The procedure of transforming the original variables in such a way that the transformed variables satisfy the assumptions of the model and applying OLS to them is known as GLS. On the other hand we have also used fixed effect as the data used in this study is panel data.

IV. Results And Discussion

In this study I have examined the role of corporate governance with financial performance to see the effects more clearly. I have chosen three different performance measures, ROA, ROE, which is anaccounting based measures.

4.1 Corporate Governance and Performance Measured By ROA
4.1.1 EGLS

Table 4.1.1
Corporate Governance and Performance Measured by ROA

Dependent Variable: ROA				
Method: Panel EGLS (Cross-section weights)				
Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	1.273469	1.169839	1.088585	0.279309373
BI	0.03626	0.013002	2.78871	0.006484947
BS	-0.07927	0.030997	-2.55728	0.012262067
CEO	-0.13589	0.046756	-2.90632	0.004625956
OC	0.010191	0.005947	1.713742	0.090096639
OC1[2]	0.019369	0.008082	2.396624	0.018663464
IND	0.017326	0.0013	13.32432	8.11E-23
GNP	0.051794	0.013042	3.971322	0.000145771
R-squared	0.703972	Mean dependent var		1.877880079
Adjusted R-squared	0.619873	S.D. dependent var		2.106272792
S.E. of regression	1.009437	Sum squared resid		89.66872678
F-statistic	8.370778	Durbin-Watson stat		1.761336991
Prob(F-statistic)	2.82E-14			

In this study we use **estimated least square regression** to identify the relationship between corporate governance and banks performance measured by ROA. Our results indicates that the corporate governance variables are statistically significant at 5% level of significance that is the P value =0.000. The signs of our variables are as expected i.e. ROA is positively related to bank performance and has significant with bank performance. The R-square is 0.703 which shows that independent variable in our analysis explains about 70% the variation in dependent variable. The results of other tests including Durbin-Watson shows that there is no autocorrelation in our data and Durbin- Watson statistics is 1.76.The F- Statistics is also significant and shows that overall significance of the variables. Thus the null hypothesis i.e. "There is no positive relationship between corporate governance in banks and its financial performance" is rejected at 5 % level of significance. This shows that corporate governance represented by BI, BS, CEO, OC, OC1, is all having has significant influence on ROA as a measure of bank performance. The signs of coefficients are as expected though the size of the coefficient is small. The other variables included in the model, the industry growth and GNP growth also seen to have significant positive influence on the performance of banks.

[1] White's General Hetroscadasticity Test was used to detect the hetroscadasticity in data.
[2] OC1 shows the percentage of shares held by individual shareholder.

4.1.1.1 Index of Corporate Index

Table 4.1.1.1
Corporate Governance and Performance Measured by ROA

Dependent Variable: ROA				
Method: Panel EGLS (Cross-section weights)[3]				
Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	0.199302	0.209271	0.952366	0.343407087
GM	-0.2958	0.127259	-2.32439	0.022305963
GNP	0.062366	0.038835	1.605912	0.111720497
IND	0.027981	0.004808	5.820013	8.50E-08
R-squared	0.862433	Mean dependent var		2.325769853
Adjusted R-squared	0.831031	S.D. dependent var		3.062201609
S.E. of regression	1.258742	Sum squared resid		145.7677798
F-statistic	27.46491	Durbin-Watson stat		1.55658787
Prob(F-statistic)	9.06E-31			

Besides measuring the independent influence of the four corporate governance variables an index of corporate governance variables was constructed by taking Geometric Mean of the given items of the corporate governance variables (board independence, board size, CEO duality and ownership concentration).GM in this table shows the index of independent variables. The results indicates that the corporate governance variables are statistically significant at 5% level of significance that is the P value =0.000. The R-square is 0.86 which means that the independent variables in our model explain the 86 percent variation in dependent variable. The results of other tests including Durbin-Watson shows that there is no autocorrelation in our data and Durbin- Watson statistics is 1.56.The F- Statistics is also significant and shows that overall significance of the variables. This shows that corporate governance has a significant negativeimpact on bank performance measured as ROA. Which means the negative impact of board size and CEO duality dominates the positive impact of board independence.

4.1.2 Fixed Effect
4.1.2.1 EGLS

Table 4.1.2.1
Corporate Governance and Performance Measured by ROA

Dependent Variable: ROA				
Method:Panel EGLS (Cross-section weights)				
Sample: 2005-2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	3.446401	1.969213	1.750142	0.083579
BI	-0.05012	0.021271	-2.35623	0.020682
BS	-0.07584	0.088861	-0.85348	0.395711
CEO	-0.11132	0.104384	-1.06642	0.289153
GNP	0.061239	0.029817	2.053849	0.042958
ING[4]	0.016241	0.003735	4.348508	3.67E-05
OC	0.01178	0.004128	2.854091	0.005381
OC1	-1.05847	1.043697	-1.01416	0.313287
R-squared	0.701892	Mean dependent var		1.995918
Adjusted R-squared	0.617202	S.D. dependent var		2.242652
S.E. of regression	1.061017	Sum squared resid		99.06658
F-statistic	8.287792	Durbin-Watson stat		1.78058
Prob(F-statistic)	3.71E-14			

4.1.2.2 Index of Corporate Index

Table 4.1.2.2
Corporate Governance and Performance Measured by ROA

DependentVariable: ROA				
Method: Panel EGLS (Cross-section weights)				

[3] Pooled least square regression was estimated but the results were not satisfactory due to problem of hetroscadasticity and autocorrelation in the data.
[4] ING represent the industry growth

Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	0.199302	0.160502	1.24174	0.217489
GM	-0.2958	0.095125	-3.10958	0.002494
GNP	0.062366	0.029908	2.085294	0.039812
ING	0.027981	0.003699	7.564889	2.86E-11
R-squared	0.753751	Mean dependent var		2.32577
Adjusted R-squared	0.697541	S.D. dependent var		3.062202
S.E. of regression	1.258742	Sum squared resid		145.7678
F-statistic	13.40975	Durbin-Watson stat		1.556588
Prob(F-statistic)	1.12E-19			

4.1.2.3 Pooled EGLS

Table 4.1.2.3
Corporate Governance and Performance Measured by ROA

Dependent Variable: ROA?				
Method: Pooled EGLS (Cross-section weights)				
Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	1.297817	1.641225	0.790761	0.431209
BI?	-0.03674	0.018004	-2.04042	0.044306
BS?	-0.07952	0.078239	-1.01634	0.312253
CEO?	-0.13646	0.106605	-1.28007	0.203885
OC?	0.010207	0.004102	2.488344	0.014717
OC1?	0.019438	0.010396	1.869716	0.064848
GNP?	0.052034	0.030518	1.705024	0.091718
IG?	0.017331	0.003832	4.522349	1.90E-05
Fixed Effects (Cross)				
_1--C	1.412635			
_2--C	0.725991			
_3--C	0.280228			
_4--C	-5.16582			
_5--C	2.10892			
_6--C	-1.71812			
_7--C	0.22018			
_8--C	-1.2042			
_9--C	1.154869			
_10--C	0.151369			
_11--C	-0.08559			
_12--C	0.418709			
_13--C	-3.02846			
_14--C	4.452773			
_15--C	2.414329			
_16—C	-3.0644			
_17—C	0.45275			
_18—C	-0.53501			
_19—C	1.008845			
R-squared	0.70473	Mean dependent var		1.881525
Adjusted R-squared	0.620846	S.D. dependent var		2.110575
S.E. of regression	1.008883	Sum squared resid		89.57037
F-statistic	8.401286	Durbin-Watson stat		1.762361
Prob(F-statistic)	2.55E-14			

4.1.2.4 Index of Corporate Index

Table 4.1.2.4
Corporate Governance and Performance Measured by ROA

Dependent Variable: ROA?				
Method :Pooled EGLS (Cross-section weights)				
Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	0.199302	0.160502	1.24174	0.217489
IND?	-0.2958	0.095125	-3.10958	0.002494
GNP?	0.062366	0.029908	2.085294	0.039812
IG?	0.027981	0.003699	7.564889	2.86E-11
Fixed Effects (Cross)				
_1--C	0.171012			
_2--C	1.374205			

_3--C	-0.40892			
_4--C	-2.35354			
_5--C	0.810684			
_6--C	-1.15887			
_7--C	0.049415			
_8--C	-0.27225			
_9--C	0.629628			
_10--C	0.680566			
_11--C	0.84007			
_12--C	0.661527			
_13--C	-3.19744			
_14--C	2.525051			
_15--C	0.35355			
_16--C	-2.37882			
_17--C	0.056432			
_18--C	0.731883			
_19--C	0.885821			
R-squared	0.753751	Mean dependent var		2.32577
Adjusted R-squared	0.697541	S.D. dependent var		3.062202
S.E. of regression	1.258742	Sum squared resid		145.7678
F-statistic	13.40975	Durbin-Watson stat		1.355232
Prob(F-statistic)	1.12E-19			

Table number 4.1.21 to 4.1.2.4 reports the results of our model with fixed effect panel EGLS approach. This was done to estimate the firm specific effect on the performance of banks.These results are very similar to the earlier results reported. Also it is noted that the firm specificeffect is strong in case of banks like MCB, ABL, FWBL, UBL, Al-Falah, Al-Habib, Meezan and NBP. The intercept values of the nineteen banks are statistically different. These differences in the intercepts may be due to unique features of each company, such as differences in management style or managerial talent.

4.2 Corporate Governance and Performance Measured By ROE
4.2.1 EGLS

Table 4.2.1
Corporate Governance and Performance Measured by ROE

Dependent Variable: ROE				
Method: Panel EGLS (Cross-section weights)				
Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-2.40809	16.39275	-0.1469	0.8835
BI	0.48092	0.207861	2.31365	0.023
BS	-0.58475	0.751494	-0.77812	0.4386
CEO	-2.16444	0.939741	-2.30323	0.0236
OC	0.312688	0.057552	5.433096	0.0000
OC1	0.16406	0.101036	1.623785	0.108
IND	0.260042	0.020538	12.66127	0.0000
GNP	0.832929	0.306489	2.71765	0.0079
R-squared	0.903764	Mean dependent var		30.2472
Adjusted R-squared	0.876424	S.D. dependent var		49.88115
S.E. of regression	17.53488	Sum squared resid		27057.53
F-statistic	33.05681	Durbin-Watson stat		1.980635
Prob (F-statistic)	0.0000			

By using the estimated generalized least square regression we identify the relationship between corporate governance and banks performance measured by ROE. The results indicates that the corporate governance variables are statistically significant at 5% level of significance that is the P value is =0.000.The R-square is 0.90 which shows that independent variable in our analysis explains the variation in dependent variable is 90%. The results of other tests including Durbin-Watson shows that there is no autocorrelation in our data and Durbin- Watson statistics is 1.980. The F- Stat is also significant and shows that overall significance of the variables. Thus the null hypothesis i.e. "there is no positive relationship between corporate governance in banks and its financial performance" is rejected at 5 % level of significance. This shows that corporate governance plays an important role in bank performance as measured by ROE.

4.2.1.1Index of Corporate Index

Table 4.2.1.1
Corporate Governance and Performance Measured by ROE

Dependent Variable : ROE				
Method: Panel EGLS (Cross-section weights)				
Sample: 2005 2010				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-3.466182849	2.039695	-1.69936	0.09263
GM	-4.955067651	1.246129	-3.97637	0.000139
GNP	1.330511257	0.378333	3.516777	0.00068
IND	0.313768022	0.046863	6.695488	1.67E-09
R-squared	0.88522453	Mean dependent var		42.76088
Adjusted R-squared	0.859025782	S.D. dependent var		58.56702
S.E. of regression	21.98988735	Sum squared resid		44487.07
F-statistic	33.78880981	Durbin-Watson stat		1.561124
Prob(F-statistic)	2.78E-34			

The index of corporate governance variables (board independence, board size, CEO duality and ownership concentration) indicates that it also has a statistically negative and significant impact at 5% level of significance that is the P value =0.000. The R-square is 0.88 which sows that independent variable in our analysis explains the variation in dependent variable is 88.52%.The results of other tests including Durbin-Watson shows that there is no autocorrelation in our data and Durbin- Watson statistics is 1.56.The F- Statistics is also significant and shows that overall significance of the variables.. This shows that corporate governance has significant impact on bank performance measured as ROE.

Thus we can conclude that corporate governance variable has a significant impact on the performance of the banks measuring by ROE. Moreover, we can say that the null hypothesis i.e. "there is no positive relationship between corporate governance in banks and its financial performance" is rejected at 5 % level of significance.

From the above mentioned all results we can conclude that corporate governance variables has a significant impact on the performance of the banks. By following the codes of corporate governance effectively and efficiently banks can improve their performance and lead at the international level. But bank should not ignore the other indicators which also have an influence on the performance of the bank like macro economic indicators, industry level variables etc which we also included in this study and the results also shows that these variables contribute in the success of banks.

4.4.1 Board Independence

We can conclude that independence of board bears positive relationship with both ROE and ROA. These emphases the independent role of board which one of the most important paradigms of corporate governance also this result is in line with the earlier studies.But with the use of fixed effect Board Independence shows negative relation with ROA, and ROE. So we can conclude that Board Independence can have the both possibilities i.e. negative and positive relation with performance measures.

4.4.2 CEO Chairman Duality

This is another area of corporate governance which requires the power to be divided and role of any person in board should not be out of balance in terms of powers and authority. Our analysis also reveals that duality is inversely related to the financial performance. So the relationship of CEO duality is negative with both ROA and ROE. This result also gets support from empirical results earlier studies conducted in the related area.

4.4.3 Board Size

The results of board size show that size of board is negatively related with all performance measures namely, ROA, and ROE. But in a pooled least square method it shows positive relationship with all performance measures ROA and ROE.

So again the results are according to empirical research which support and document the evidence of both possible and negative relationship of size with performance.

4.4.4 Ownership Concentration

The results of ownership concentration show that ownership concentration is positively associated with ROA and ROE. This shows that ownership concentration has positiveinfluence on the value of the firm.

In a pooled least square method ownership concentration shows negative relation with ROE, but has positive relationship with ROA.Empirical studies by Bebchuk, Stieglitz, propose that ownership concentration may have negative influence on the value of firm, because large shareholders has the power to have dominant control at the expense of minority shareholders.

4.4.5 GNP and Industry Growth

The results of GNP growth shows thatit has a significant impact on the performance of banks measured by ROA and ROE, but it seems to have significant negative influence on the performance of the banks.This may be so because of the time period taken during which GDP growth had declined.

On the other hand, industry growth shows significant positive influence on the performance of the banks. Obviously the banking sector growth has remained positive and quite strong.

4.4.6 Firm Specific Characteristics: Firm specific characteristics are explained by the fixed effect analysis.

V. Conclusion And Recommendations

5.1 Conclusion

It can be concluded now that after the implementation of code of Corporate Governance in Pakistan the image of the banking sector is getting better and better. Corporate Governance is an important thing in developing countries like Pakistan and because of the implementation of code of Corporate Governance, Pakistan's stock market is also moving towards the betterment.

During the last few years Pakistan's banking sector changes from nationalized commercial banks to private banks. Banking sector is the most important channel of resource allocation and mobilization in an economy. A banking sector collapse may have devastating impact on the economy. So it is important to take necessary steps to ensure banking stability. As a result State Bank of Pakistan issued guidelines for corporate governance of banks in Pakistan. These guidelines are drawn from the recommendations provided by the IMF, OECD, Basel Committee, etc but modified according to domestic economic environment and rules and regulations.This study examines Corporate Governances practices and their impact on Performance in Pakistan. Towards the end I can say that the variable I have discussed in this study definitely have impact on financial performance, how ever there are other governance variables which are not included on this data do also have impact on the corporate governance, these include the structure of board, qualifications of board, remuneration structure.

5.2 Recommendations

Corporate governance entails a set of rules and standards, which govern the relationship between a company's directors, management, its shareholders and other stakeholders. These rules and standards initiated in the last few years by the SECP and are a vital component of the growth revival strategy being pursued by the government aiming at improvement in existing corporate governance practices and systems.

If the SECP and SBP ensure good governance practices by forcing them on the corporate sector of Pakistan, such a move by SBP and SECP would be extremely counter productive to the economy as a whole. Therefore it is strongly recommended that the code of Corporate Governance by implemented through proper process. One of the essential features of this implementation should be the focus on developing other support institutions simultaneously. To improve the image of the companies a combined code of corporate governance should be made mandatory for the public limited banks so that there will be less margin of error and there will be lesser misuse of the investor's wealth. Corporate Governance system that has the ability to efficiently raise external capital, increase corporate competitiveness and stimulate organizational growth. Therefore it is very important that code should be applied to all banks without any delay. However, some degree of flexibility can be shown to small and new banks.So there is a strong need of further research in area and I feel that my preliminary work substantially contributes to our understanding of relationship between corporate governance and financial performance, moreover I have only taken public and domestic private sector commercial banks, governance parameters is equally important to specialized and foreign banks in Pakistan.

Furthermore while analyzing the data I have seen great deal of variation in presentation of governance data, which give space for misrepresentation and misstatement of facts relating to corporate governance.

As the requirement of code of corporate governance banks has declare separately the details relating to compliance to the code of corporate governance, still that compliance statement need to improve and must be little more objective in nature leaving less scope for business to manipulate the facts.

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AppendixI

Table 1: Bank List

Sr. No.	Banks Name
1	First Women Bank Ltd.
2	National Bank of Pakistan
3	The Bank of Khyber
4	The Bank of Punjab
5	Allied Bank Ltd.
6	Arif Habib Bank Ltd.
7	Askari Bank Ltd
8	Bank Al -Falah Ltd.
9	Bank Al -Habib Ltd
10	Faysal Bank Ltd
11	Habib Bank Ltd
12	Habib Metropolitan Bank Ltd
13	KASB Bank Ltd
14	MCB Bank Ltd
15	Meezan Bank Ltd
16	NIB Bank Ltd
17	Soneri Bank Ltd.
18	Standard Chartered Bank (Pakistan) Ltd.
19	United Bank Ltd.