The Effect of Corporate Governance on Capital Structure Decisions – A Case of Saudi Arabian Banking Sector

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Abstract: The aim of this empirical study is to analyse the impact of Corporate Governance on Capital Structure Decisions in Saudi Arabian commercial banking sector. The components of corporate governance whose impact has been analysed on the capital structure are board size, independence of directors, ownership structure, ownership of management, board meetings. Multiple regression analysis, Correlation matrix and Descriptive Statistics is used to assess the relationship among corporate governance components and capital structure of Saudi commercial banks for the years 2010 and 2011. The results shows that ownership structure and board size are positively correlated which is coherent with most of the previous studies. Managerial ownership and board independence are negatively correlated and board meeting held in a year is also negatively correlated but is statistically insignificant. Moreover the study found that on average the Saudi banks uses 68 % debt capital. The research study is supposed to facilitate regulatory authorities like CMA for improving the implementation of rules and regulations in order to make corporate governance tools work more efficiently in the Kingdom of Saudi Arabia. The research study evaluates the effects of corporate governance components on capital structure decisions of Saudi commercial banks.

Keywords: Commercial Banks; Capital Structure Decisions; Corporate Governance

JEL Classification: G21; G32; G34

Introduction

Corporate governance is a widely researched topic in the literature due to the fact that many corporate scandals such as Enron, Asian financial crises and recent credit crunches occurred due to lapses in governance. Corporate governance is a set of rules and regulation through which an organization is directed and controlled.

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Corporate governance describes the rights and responsibilities of all the stake holders in an organization. Structure of corporate governance consists of a wide range of practices, policies and foundations which include accounting standards related to fair financial disclosure, executive compensation, size and composition of corporate boards audit committees.

Corporate governance of banks seems to be more important than other industries because the banking sector plays a crucial financial intermediary role in any economy, particularly in developing countries. Poor corporate governance of the banks can drive the market to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a liquidity crisis and then it might lead to economic crisis in a country and pose a systemic risk to the society at large (Cebenoyan & Strahan, 2004; Basel Committee on banking supervision, 2008; Garcia-Marco & Robles-Fernandez, 2008). Therefore, it is important to examine the effect of corporate governance mechanisms in the banking sector. Research on corporate governance has tried to examine its impact of the financial performance of business entities (Rebeiz and Salameh, 2006; Fosberg and Nelson, 1999; Kenourgios et al., 2007).

A lot of research work has been carried out about bank stability, accounting performance, efficiency, ownership structure, agency issues, board structure and even corporate governance as whole impacts on the performance of banks, but corporate governance and the performance in the country like Saudi Arabia the banking sector is remotely touched. Taking this fact into consideration this study focusses on the relationship between corporate governance and the capital structure decisions of Commercial banks Listed in Saudi Arabian Stock Exchange (TADAWUL).

Corporate Governance in Saudi Arabia

The crash of TADAWUL in 2006 and subsequent suspension of trading for two firms created a serious question about the usefulness of monitoring procedures that were supposed to protect the investors in the country. In response to these events and to further strengthen the investors' interests the Corporate Governance Regulation were designed and issued by the Capital Market Authority (CMA) in November the same year. These regulations comprises though the rules and standards that control the management of companies that are listed in TADAWUL to confirm their agreement with the best governance practices in order to safe guard the investors' rights. These directives addressed the issues of right of stockholders, disclosure requirements, boards of director's features and audit committees specifications. These regulations were taken from the best practices around the world with a point of view of their easy and flexible implementation in the Saudi companies in the later years. This flexibility created dissimilarities among corporations with regard to the implementation of these regulations. Still there are many voluntary requirements exist with regard to the implementation of corporate Governance regulations in the firms as the implementation of best practices are in the hands of chief executive and board directors which can create further agency issue in some cases. Although the Banking sector is strictly managed with regard to monetary regulations and international BASEL agreements but still the area ofCG requirements fulfilled by the sectors is under researched. This study is an effort in this direction to find out the impact and relationship of Corporate Governance on capital structure of Commercial banks in the country.

Literature Review

Corporate Governance and Capital Structure Decisions

Corporate governance and capital structure relationship has been studied by a number of researchers such as Berger et al(1997) in which They Found positive relationship between board size and leverage level. Wen et al (2002) and Abor (2007) also found positive relation between board size and capital structure. Berger et al (1997) and Abor (2007) found positive correlation between board composition and capital structure. Wen et al (2002) found negative relation between number of external directors and leverage level.

Many empirical studies have shown that some corporate governance features which have influence on the financing decisions of Company include board size, Independent directors, ownership concentration and structure, ownership managerial control and meeting attended during the year (Anderson et al., 2004; Bokpin and Arko, 2009; Choe and Lee, 2003; Fosberg, 2004; Friend and Lang, 1988, 2006; Mehran, 1992). All of the above mentioned components of corporate governance are briefly discussed below in the light of previous literature.

Size of Board of Directors

Most of the Researchers are of the view that effective and efficient board is vital to the success of a company. It is the responsibility of the board to provide strategic direction to ensure the company's development and maximize the shareholders wealth. Boardis also charged with the duty of supervising and monitoring the senior management of the corporation. In the view of Adams and Mehran (2003) it is easy for bigger board to effectively monitor the actions of management and to deliver better performance. While Lipton and Lorsch (1992) proclaims that large boards are less operative compared to small boards because the conflict and disagreement that can arise among the members. The available literature on board size and capital structure harvests mixed findings where Berger et al. (1997) found a significant and negative correlation between board size and Financing decisions and Wiwattanakantang (1999) established that board size is negatively correlated with capital structure but this association is statistically insignificant. Anderson et al. (2004) established the same relationship. On the contrary Abor (2007) and Bokpin and Arko (2009) found a significant positive relationship between size of the board and capital structure of corporations.

Independence of Directors

Independent directors on the boards are more privileged as they are normally considered to have better knowledge, vision and Independence from management. If there are more independent directors it means they can monitor the actions of the management more closely and take appropriate actions specially in respect of implementing corporate governance regulations.

The top managers face more dynamic checking when their performance is measured by independent or outside directors (Weisbach, 1988). There is another factor that with more needs for entrance to the capital market it is expected to have greater number of independent directors for the companies.

There are mixed results yielded in the literature regarding board composition where Berger et al. (1997) have shown that debt is significantly lower when a there is a low percentage of independent directors. While, Wen et al. (2002) stated a significant negative relationship between board composition and capital structure that means the managers are reluctant to take more loans in presence of more independent directors. This negative association is also found between board independence and leverage by Anderson et al. (2004). In another study Abor (2007) established a positive correlation between debt and independent directors while Bokpin and Arko (2009) found a positive and insignificant relationship between board independence and the leverage in the company.

Ownership Structure

The ownership concentration may also help to alleviate the agency problems between managers and stockholders. Many institutional investors and large shareholders have more ability than ordinary shareholders to influence the managerial decisions and actions. According to Brailsford et al. (2002) there is statistically significant relationship between ownership concentration and capital structure with respect to debt financing and Fosberg (2004) established that the amount leverage in the capital structure is directly related to the proportion of ownership structure and concentration. Mehran (1992) stated a positively statistically significant correlation between ownership by large investors and debt in the firm.

Ownership of Management

Research studies have found diverse outcomes about the relationship between managerial ownership and capital structure. A study by Berger et al. (1997) has found a positive and significant relationship between debt capital and CEO's ownership telling that managers whose financial benefits are associated with external stockholders will adopt more debt capital structure to raise the worth of the organization.

Mehran (1992) also found a positive correlation between managerial ownership and capital structure proposing that ownership in company induce the manager to increase firm debt capital. Organizations with higher managerial ownership have more debt capital than firms with lower managerial ownership (Kim and Sorensen, 1986). A study conducted by Brailsford*et al.* (2002) found that the correlation between managerial ownership and debt capital could be nonlinear if the managerial ownership decreases the agency conflicts will reduce, arising a higher debt capital. But if the management already hold a significant ownership of firms' equity, then an increase in managerial ownership will lead to more managerial opportunism and it will cause lower debt.

Some studies such as Wiwattanakantang (1999), Bokpin and Arko (2009) found insignificant relation between ownership and capital structure, while others such as Bathala et al. (1994) negative relation between managerial ownership and capital structure.

Methodology

Total population of listed commercial banks which consists of 10 banks Listed in Saudi Arabian stock exchange (Tadawul) is selected for this study. The study covers two years data from 2010 and 2011 to study the impact of Corporate Governance components on capital structures of the listed banks. In the model the capital structure of the commercial banks is taken as a dependant variable while components of corporate governance are taken as independent variables. Various components of Corporate Governance which were in inculcated in this study include Board Size and Independence, Ownership structure the ownership of Management and meetings held during the year.

To calculate the dependant and independent variable following reliable measures have been used to find the relationship of Corporate Governance and Capital structure.

Capital Structure of banks= Total Liabilities- Current Liabilities/ Total Assets – Current Liabilities

Board size= the Number of Directors in the bank

Independence =Non-executive directors/ Total number of Directors

Ownership Structure= Top shareholders / Total number of shares outstanding

Ownership of Management= Share held by board members and their close relative/ Total number of shares outstanding

Board Meetings Held = Meeting held during the year

The data was collected from the Audited Annual reports of the banks and an analysis was conducted on the basis of above mentioned criteria. Following Hypothesis has been developed to study the relationship.

H1: there is a strong effect of Corporate Governance on Capital Structure of commercial banks in Saudi Arabia.

H0: there is a weak effect of corporate governance on capital structures of commercial banks in Saudi Arabia.

The Empirical Model:

Multiple regression approach of OLS model is applied to find the strength of the above mentioned hypothesis. Panel data was used to decrease the chances of error and to improve the overall efficiency.

The model is as under:

$CSB=\beta0+\beta1BS+\beta2I+\beta3OS+\beta4OM+\beta5BMH+\mathcal{E}i$

The Model denotes that intercept is β0 having a fixed effect on capital structure while Ɛi is the standard error in the model. CSB is the dependant variable used in the above model.The coefficients of independent variables are from β1 to β5 while BS, I, OS, OM and BMH are independent variables in the model.

In order to better explain the required relationship the study uses the correlation matrix and descriptive statistics by using the Excel Spread sheet.

Results and Analysis

The table1 below shows the results of multiple regression analysis. The OLS Model gives the coefficient of determination R square which is equal 57.6% which means a reasonable proportion

Of dependant variable (Capital structure of banks, CSB) is explained by Independent variables (BS, I, OS, OM and BMH). The overall significance of the regression model which is measured by F –statistic shows relatively weak about 48% of regression results can be by chance. Moreover the Probability values or P-values are above the significance level of 5% which shows weak relationship between dependant and independent variable. This is also evident from the smaller values of t Statistic. While the beta coefficients shows some positive and negative values of independent variables.

The table 2 is about the correlation matrix which tells the individual relationship among various variables of the study. The results show that only Ownership Structure and Board size are positively correlated with the capital structure of banks. While Independence, Managerial ownership and Board meetings held are negatively correlated with the dependant variable. Ownership structure has a significant positive correlation with Capital structure of the banks as 1 unit change OS will lead to more 40% change in capital structure while 1 unit change in board independence will negatively affect the capital structure by almost 50%. The correlation between OS and OM Has a very high negative correlation which means the ownership structure is negatively affected by increase or decrease in ownership of management.

In Table 3 the summary of descriptive statistic is mentioned which has the some key information. On average the banks uses 68% debt to finance its operations. It is quite low when compared to international standards where it is more than 80% for banking industry. This is due to bank Al Rajhi An ALINMA where both the banks uses more equity finance, Al Rajhi has 65% and ALINMA has 76% of equity financing generally due to support its Islamic banking operations.

Board Size consists of 10 members on average. Board Independence is about 41%. The Ownership structure shows 51% shares are held by few large shareholders mostly institutional investors. The Ownership of Management is about 13% which is high due to al Rajhi bank having more than 40% of control of its own board members. The meetings are 6 to 7 in a year on average.

Regression Statistics	
Multiple R	0.758952689
R Square	0.576009184
Adjusted R	0.046020665
Standard Error	0.195403088

	df	***SS***	***MS***	***F***	***Sig F***
Regression	5	0.207489342	0.041497868	1.086833324	0.481276528
Residual	4	0.152729467	0.038182367		
Total	9	0.360218809			

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	1.431238792	1.169150949	1.22416938	0.288058887
OS	0.739700377	0.557161019	1.327624064	0.255001445
I	-2.438714475	1.283380136	-1.900227693	0.130204652
OM	0.728242559	0.760634683	0.957414348	0.392575461
BS	0.013895459	0.101027917	0.137540783	0.897248954
BMH	-0.056441379	0.052052179	-1.084323079	0.33920669

	CSB	*OS*	*I*	*OM*	*BS*	*BMH*
CSB	1					
OS	0.418100474	1				
I	-0.493036706	0.032642534	1			
OM	-0.268462604	-0.733750064	0.034737492	1		
BS	0.053057438	0.331084339	0.340459108	-0.250655823	1	
BMH	-0.014734034	-0.317028416	-0.558550138	0.545472091	-0.3811274	1

Descriptive and
Correlation Statistics

	CSB	OS	I	OM	BS	BMH
Mean	0.67651	0.51691	0.4127	0.13168	10.1	6.5
Standard Error	0.063264771	0.0586802	0.023259908	0.05328498	0.23333333	0.6871843
Median	0.7485	0.5075	0.4	0.075	10	6
Mode	0.74	N/A	0.4	0.01	10	5
Standard	0.200060771	0.185563086	0.073554288	0.168501901	0.73786479	2.1730675
Sample	0.040024312	0.034433659	0.005410233	0.028392891	0.54444444	4.7222222
Kurtosis	1.473985752	-0.510524505	-0.328710377	1.261628345	-0.7336229	-1.240336
Skewness	-1.691801325	-0.583202966	0.23903243	1.5881175	-0.1659504	0.4872483
Range	0.5681	0.549	0.24	0.47	2	6
Minimum	0.26	0.173	0.3	0.01	9	4
Maximum	0.8281	0.722	0.54	0.48	11	10
Sum	6.7651	5.1691	4.127	1.3168	101	65
Confidence	0.143114854	0.132743835	0.052617568	0.120538999	0.52783667	1.5545188

Conclusion

This research study tried to find the effects of corporate governance on the capital structure of all the ten listed commercial banks of Saudi Arabia for the years 2010-2011. Capital Structure (total debt-current liabilities/total asset-current liabilities) is taken as a dependent variable while corporate governance components are taken as independent variable, which include board size, independence of board, ownership structure, ownership of management and board meeting held in a year.

The results shows that ownership structure and board size are positively correlated which is coherent with most of the previous studies. Managerial ownership and board independence are negatively correlated and board meeting held in a year is also negatively correlated but is statistically insignificant. Moreover the study found that on average the Saudi banks uses 68 % debt capital. The average is low because bank Al Rajhi and Bank Alinma uses mainly equity capital. About 51% shares in Saudi commercial banks are held by large mainly institutional owners. Furthermore the study reveals that 13% shares in Saudi commercial banks are held by the management and their close relatives, again it relatively high due to Bank Al Rajhi. The findings suggest that more studies should be conducted to investigate the weak relationship between corporate governance and capital structure in Saudi banks and more variables for corporate governance such as role of Committees, auditor independence, foreign ownership and minority ownership should be added. The study has limitations especially regarding data availability which covers two years and the small size of total population in the banking sector of the country.

There are also some policy issues that should be addressed on the basis of this study about the extent and nature of the regulation of the corporate governance in banking sector of Saudi Arabia by CMA and other regulatory bodies like Saudi Arabian Monetary Agency (SAMA). The empirical findings state to there is insignificant relationship between corporate governance and capital structure that suggests more regulations are required so that corporate governance can play appropriate and desired role in the commercial banking sector of Saudi Arabia.

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