

Better Boards Towards Higher Profitability

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This paper will examine the impact of corporate governance on the profitability of banks using the agency theory. The profitability of banks is measured by return on assets (ROA) and return on equity (ROE). A total of twelve listed bank holding companies are examined over a ten-year period. Based on the panel data analysis, none of the conventional measures of corporate governance is significant as hypothesized. Board's independence and institutional ownership have negative impact on ROE significantly. Apart from that, as the findings of the effect of corporate governance on bank profitability are inconclusive, other factors such as culture, local prevailing laws and business environment, might need to be considered.

Field of Research: corporate governance, profitability, bank, board, Malaysia

1. Introduction

Issues of corporate governance are not new (Vinten 1998). They have emerged with the birth of corporations (Grant 2003). However, corporate governance becomes an attractive issue in Asian countries, including Malaysia, in the late 1990s following the 1997-1998 crisis (Cheung & Chan 2004; Tze 2003). Many researchers such as Clarke (2004), Spremann (2002), Connelly and Limpaphayom (2004) and Mueller (2006) believe that weak corporate governance is one of the causes of 1997/1998 economic crisis. Hence it is necessary to develop good corporate governance system to restore investor confidence, especially for the countries, which have experienced financial crisis (United Nations 2003). Due to this crisis, the Malaysian Code on Corporate Governance (MCCG) was developed in March 2000 by the Working Group of Best Practices in Corporate Governance (Satkunasingam & Shanmugam 2004). The Code became effective on 1st June 2001 (Mak & Li 2001) as it became mandatory for the listed companies to comply with its recommendations. Therefore, the objective of this paper is to examine the impact of corporate governance on profitability of Malaysian listed banks.

Previous empirical findings on the relationship between corporate governance elements such as board leadership structure, board composition, board size and ownership structure, and financial performance, have provided mixed results. These findings have further supported the perceptions of complicated views on the theories of corporate governance. Although the agency theory is quite dominant in the corporate governance literature, the environment and culture within which the companies operate, together with the prevailing local laws might have effected on the relationship between corporate governance and profitability. In addition, most of the prior researchers focused on the relationship between governance and performance in the nonfinancial sectors, and thus this study examines specifically in the banking sector, where more tighten corporate governance regulation is imposed.

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This study has included ownership variables (i.e. director ownership, institutional ownership and block ownership) together with the conventional corporate governance variables (i.e. board leadership structure, board composition and board size) in explaining profitability of banks. In addition, banks' specific characteristics (i.e. size and leverage) have also been added as control variables in the models. Finally, this study has also included macroeconomics indicators (i.e. gross domestic product growth rate and economic crisis variables) as additional control variables since this study spans over a long period of time (i.e. ten years).

The structure of this paper is as follows. The second section presents the theoretical framework of the study. The third section elaborates on the research methodology adopted in this paper. Within the section, it discusses related literature, leading to the development of the hypotheses. The fourth section will describe the results. The fifth section discusses the findings and the last section concludes this paper.

2. Agency Theory and Corporate Governance

According to Jensen and Meckling (1976), the agency relation is defined as a contract under which one party (the principal) engages another party (the agent) to perform some service on the principal's behalf. The principal will delegate some decision-making authority to the agent. According to the agency theory relationship, directors (as agents), are delegated the authority by the shareholders (as principals) to monitor the management of the company. Therefore, the directors are indirectly responsible for the smooth running of the company, which is in line with the interests of the shareholders. However, due to the separation of ownership and control, agency problems, i.e. moral hazard (hidden action) and adverse selection (hidden information) could occur and the directors might maximize their own interests at the expense of the shareholders.

Hence, there should be some mechanism that could align the interests of principals with the interests of agents (Judge, Naoumova & Koutzevol 2003). The suggested mechanism is good corporate governance by which this conflict of interest can be resolved to a certain extent (Gursoy & Aydogan 2002) since it promotes goal congruence (Conyon & Schwalbach 2000). Good corporate governance structure such as separation of the roles of the CEO and the chairman, inclusion of independent non-executive directors in board composition, and smaller board size have been proposed by various researchers using the agency theoretical framework (e.g. Jensen & Meckling 1976; Fama and Jensen 1983; Jensen 1993; Choe and Lee 2003). Short et al. (1999) and Cheung and Chan (2004) also describe that the ultimate goal of corporate governance is to monitor the management decision-making in order to ensure that it is in line with shareholders' interests, and to motivate managerial behavior towards enhancing the firms' wealth.

3. Research Methodology

Many researchers such as Bauer, Eichholtz and Kok (2010), Braga-Alves and Shastri (2011), Afsham, Chetri and Pradhan (2011) and Iqbal and Zaheer (2011) highlight the important role of corporate governance in contributing firm profitability. According to them, for any company, having a good corporate governance system is essential and the first step to be instilled in order to ensure that the management is under a

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good supervision of the board of directors. Thus, the following paragraphs will elaborate on the development of hypotheses to test whether good corporate governance system can contribute towards higher firm profitability.

3.1 Development of Hypotheses

Regarding board leadership structure, agency theory argues for a clear separation of the responsibilities of the CEO and the chairman of the board and seems to prefer to have separate leadership structure (Jensen & Meckling 1976; Fama & Jensen 1983; Jensen 1993). The reason is that since the day-to-day management of the company is led by the CEO, the chairman of the board, as a leader of a board, needs to monitor the decisions made by the CEO which will be implemented by the management and to oversee the process of hiring, firing, evaluating and compensating the CEO (Brickley, Coles & Jarrell 1997; Weir 1997). If the CEO and the chairman of the board is the same person, there would be no other individual to monitor his or her actions and he or she will be very powerful and may maximize his or her own interests at the expense of the shareholders. The combined leadership structure promotes CEO entrenchment by reducing board monitoring effectiveness (Finkelstein & D' Aveni 1994; Florackis & Ozkan 2004). Thus, a separate leadership structure is recommended in order to monitor the CEO objectively and effectively. The findings of Fosberg and Nelson (1999), Chen et al. (2005), Chiang (2005), Kula (2005), and Rebeiz and Salameh (2006) are in line with theoretical expectation, i.e. a positive relationship between separate leadership structure and profitability. Thus, the first hypothesis of the study, in its alternative form, is stated as follow.

H_{a1}: Profitability is positively related to separate board leadership structure

Board composition is very important to effectively monitor the managers and reduce the agency cost (Choe & Lee 2003). Although the executive directors have specialized skills, expertise and valuable knowledge of the firms' operating policies and day-to-day activities, there is a need for the independent directors to contribute the fresh ideas, independence, objectivity and expertise gained from their own fields (Weir 1997; Firth, Fung & Rui 2002; Cho & Kim 2003). Hence, the agency theory recommends the involvement of independent non-executive directors to promote the independence of the board from management. The reason for this recommendation is that if the majority of the board members are executives of the company, the board will more likely be manipulated by the managers and the decision made by the board might be biased and it might favor the interests of the management, not the shareholders (Le, Walters & Kroll 2006). Thus, the agency theory suggests a greater proportion of independent non-executive directors to monitor any self-interested actions by managers and to minimize agency costs (Kiel & Nicholson 2003; Florackis & Ozkan 2004; Williams et al. 2006). The studies conducted by Liang and Li (1999), Dehaene, Vuyst and Ooghe (2001), Prevost, Rao and Hossain (2002), Bozec and Dia (2005), Krivogorsky (2006), and Rebeiz and Salameh (2006) highlight the importance of independent directors. Thus, the following hypothesis is developed.

H_{a2}: Profitability is positively related to higher proportion of independent non-executive directors

Regarding board size, Jensen and Ruback (1983) and Florackis and Ozkan (2004) mention that boards with more than seven or eight members are unlikely to be

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effective. They further elaborate that large boards result in less effective coordination, communication, and decision-making, and are more likely controlled by the CEO. Yoshikawa and Phan (2003) also highlight that larger boards tend to be less cohesive and more difficult to coordinate because there might be a large number of potential interactions and conflicts among the group members. In addition, Yoshikawa and Phan (2003) further state that large boards are often created by CEOs because the large board makes the board members disperse the power in the boardroom and reduce the potential for coordinated action by directors, leaving the CEO as the predominant figure. In sum, smaller boards seem to be more conducive to board member participation and thus would result in a positive impact on the monitoring function and the strategic decision-making capability of the board, and independence from the management (Huther 1997). The findings of Yermack (1996), Eisenberg, Sundgren and Wells (1998), Mak and Kusnadi (2004), and Andres, Azofra and Lopez (2005) support that there is a negative relationship between board size and firm's profitability. The above arguments lead to the development of the next hypothesis, which is as follow.

H_{a3}: Profitability is positively related to smaller board size.

Agency theory stresses the importance of ownership structure in enhancing corporate governance. It could be viewed from three different perspectives; (a) managerial ownership, (b) block ownership, and (c) institutional ownership. Higher portion of the ownership will encourage the owners to monitor the performance of the companies, compared to the smaller ownership. It is also supported by Seifert, Gonenc and Wright (2005) who discuss agency conflicts. The findings of Sanders (1999), Fuerst and Kang (2004), Chiang (2005) and Shen, Hsu and Chen (2006) show there is a positive relationship between director ownership and profitability. Xu and Wang (1999), Hamadi (2002), Mitton (2002), Sakai and Asaoka (2003) and Krivogorsky (2006) find that there is a positive relationship between block ownership and profitability. The findings of Xu and Wang (1999), Dwivedi and Jain (2003), Patibandla (2006), Leng (2004), Shen, Hsu and Chen (2006), Krivogorsky (2006), and Cornett et al. (2007) are in line with theoretical expectation. This means that higher institutional ownership will lead to higher profitability. Based on the agency theory, the following hypothesis in an alternative form is developed.

H_{a4}: Profitability is positively related to higher proportion of director ownership, higher proportion of block ownership and higher proportion of institutional ownership.

3.2 Empirical Model and Variables' Definition

In this section, the empirical model of the study will be presented. The dependent variable is profitability of the banks, which are measured using two proxies; return on assets (ROA) and return on equity (ROE). There are six independent variables, which comprise of three conventional measures of corporate governance (i.e. board leadership structure, board composition and board size) and three measures of ownership structure (i.e. director ownership, institutional ownership, and block ownership). Finally, the empirical model of the study also includes four control variables; two control variables related to firm-specific characteristics (i.e. firm size and leverage), and two control variables related to economic environment (i.e. gross domestic product rate and economic crisis). The complete empirical model is as follows.

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$$\text{PERF} = \beta_0 + \beta_1 \text{BLS} + \beta_2 \text{INE_BZ} - \beta_3 \text{BZ} + \beta_4 \text{DOWN} + \beta_5 \text{IOWN} + \beta_6 \text{BOWN} + \beta_7 \text{LNTA} + \beta_8 \text{TD_TE} + \beta_9 \text{GDP RATE} + \beta_{10} \text{DUM_CRISIS} + \varepsilon_{it}$$

Where,

| | |
|------------|--|
| PERF | = Profitability is measured by ROA and ROE |
| BLS | = Board leadership structure where 1 = separate leadership structure, and 0 = combined leadership structure |
| INE_BZ | = Proportion of independent non-executive directors on the board |
| BZ | = Board size |
| DOWN | = Proportion of director ownership |
| IOWN | = Proportion of institutional ownership |
| BOWN | = Proportion of block ownership |
| LNTA | = Firm size, measured by Log of total assets |
| TD_TE | = Leverage, measured by total assets over total equity |
| GDP RATE | = Gross domestic product growth rate |
| DUM_CRISIS | = Dummy variable for economic crisis years, where 1 = crisis year, and 0 = non-crisis year |

3.3 Samples and Statistical Method

Samples include the twelve listed companies whose main activity is banking from 1996 to 2005. Sample period is ten years, i.e. five years before and after MCGG is introduced. The total number of observations is 120 observations. However, some of the observations are dropped due to unavailability of data and some companies were not classified as banks in all the ten years' period. It left the final observations to 108 observations. Data were collected either from the annual reports of the companies or from Bloomberg. The statistical method used in this study is panel data analysis (generalized least square method). Generalized least square method is used because the sample data are not normally distributed and the data have either heteroscedasticity problem, autocorrelation problem or both since this method will overcome all these problems.

4. Discussion on Findings

Results of descriptive statistics are explained first. It will be followed by the discussions on the GLS multivariate regression results on the relationship between corporate governance variables and firm profitability.

4.1 Descriptive Statistics

Table 1 shows the descriptive statistics of the variables utilized in the study. In case of board leadership structure, its mean value (0.81) shows that a majority of the companies have separate leadership structure although the minimum value (zero) shows that there are companies, which have combined leadership structure. Regarding board composition, the MCGG (2001) recommends that at least one of the board members should be independent non-executive directors. The mean value (0.36) shows that, on average, the proportion of the independent non-executive

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directors of sample companies is more than one third of the total number of the directors on the board. Concerning with board size, the mean value (8.23) shows on average, the sample companies have quite reasonable larger board size, e.g. Jensen and Ruback (1983) suggest that a board size of not more than 7 or 8 members is considered reasonable in ensuring effectiveness. For ownership, the mean values of director ownership and institutional ownership are 0.02 and 0.17 respectively. The ownership of shares by directors can be considered very low where, on average, only 2 percent of shares owned by the directors. On the other hand, institutional investors, on average, owned 17 percent of shares, which could still be considered low although it is significantly higher than the ownership by the directors. In the case of block ownership, its mean value (0.53) shows that large shareholders own the significant portion of the shares.

Table 1: Descriptive Statistics Results

| | Mean | Std. Dev. | Min | Median |
|--------------------------------|------|-----------|---------|--------|
| Independent variables | | | | |
| <i>(a) CG variables</i> | | | | |
| BLS | 0.81 | 0.40 | 0.00 | 1.00 |
| INE_BZ | 0.36 | 0.18 | 0.10 | 0.33 |
| BZ | 8.23 | 2.34 | 4.00 | 8.00 |
| <i>(b) Ownership variables</i> | | | | |
| DOWN | 0.02 | 0.05 | 0.00 | 0.00 |
| IOWN | 0.17 | 0.18 | 0.00 | 0.09 |
| BOWN | 0.53 | 0.21 | 0.00 | 0.58 |
| Dependent variables | | | | |
| ROA | 0.62 | 1.11 | -5.62 | 0.83 |
| ROE | 6.07 | 28.08 | -132.52 | 9.31 |

Where,

- BLS = Board leadership structure
- INE_BZ = Ratio of independent directors to the board
- BZ = Board size
- DOWN = Ratio of director ownership
- IOWN = Ratio of institutional ownership
- BOWN = Ratio of block ownership
- ROA = Return on Assets
- ROE = Return on Equity
- TA = Total assets
- TD_TE = Ratio of total debt to total equity
- GDP RATE = Gross domestic product rate

The means values of dependent variables are: for return on assets (0.62) and return on equity (6.07). There is a significant difference on the mean values of ROA and ROE, as for banks; their amount of equity is quite small compared to the amount of assets. As for the firm-specific characteristics, the sample companies have the means values of RM45992.19 millions for total assets and 344.73 for the ratio of total debt to total equity. Finally, the average GDP rate is 8 percent per annum.

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4.2 Findings of Return on Assets

ROA and ROE measure the profitability. The findings for each measure of profitability will be explained in the following paragraphs.

Table 2: GLS results of return on assets

| | Coefficient | T_statistics | P value |
|-----------------------------------|--------------|----------------|---------------|
| <i>Independent variables</i> | | | |
| BLS | 0.29 | 1.28 | 0.20 |
| INE_BZ | -0.77 | -1.57 | 0.12 |
| BZ | -0.03 | -0.79 | 0.43 |
| DOWN | -2.11 | -1.11 | 0.27 |
| IOWN | -1.23 | -2.71* | 0.01 |
| BOWN | -0.52 | -1.79 | 0.07 |
| <i>Control variables</i> | | | |
| LNTA | 0.25 | 2.12** | 0.03 |
| TD_TE | 0.00 | -1.94** | 0.05 |
| GDP RATE | 4.99 | 4.48* | 0.00 |
| DUM_CRISIS | -0.16 | -1.02 | 0.31 |
| CONS | -1.34 | -1.34 | 0.18 |
| Chi-Sq. | | | 58.25* |
| P value | | | 0.00 |
| Heteroscedastic (LR Test) | LR Chi2 | 87.01* | |
| | P value | 0.00 | |
| Autocorrelation (Wooldridge Test) | F statistics | 1.16 | |
| | P value | 0.30 | |
| * Significant at 1% | | | |
| ** Significant at 5% | | | |

Based on the results shown in Table 2, institutional ownership has a significantly negative impact on profitability at one percent for return on assets, contradicting our expectation of a positive relationship. Other independent variables are insignificant. Furthermore, the sign of the predicted relationship between the ROA and the independent variables are contradictory, except for board leadership structure and board size. Therefore, the only significant relationship is between the ROA and institutional ownership. However, the sign of the relationship contradicts the expectation, and thus the hypothesis is not supported.

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4.3 Findings of Return on Equity

Table 3: GLS results of return on equity

| | Coefficient | T_statistics | P value |
|-----------------------------------|---------------|----------------|----------------|
| <i>Independent variables</i> | | | |
| BLS | 0.82 | 0.17 | 0.86 |
| INE_BZ | -12.84 | -2.03** | 0.04 |
| BZ | -0.04 | -0.08 | 0.94 |
| DOWN | -53.60 | -1.01 | 0.31 |
| IOWN | -22.52 | -3.23* | 0.00 |
| BOWN | -1.71 | -0.37 | 0.71 |
| <i>Control variables</i> | | | |
| LNTA | 3.04 | 2.26** | 0.02 |
| TD_TE | -0.01 | -1.45 | 0.15 |
| GDP RATE | 87.14 | 4.76* | 0 |
| DUM_CRISIS | -0.70 | -0.28 | 0.78 |
| CONS | -17.80 | -1.42 | 0.16 |
| Chi-Sq. | | | 45.34* |
| P value | | | 0 |
| Heteroscedastic (LR Test) | LR Chi2 | | 224.33* |
| | P value | | 0 |
| Autocorrelation (Wooldridge Test) | F statistics | | 79.38* |
| | P value | | 0 |
| * Significant at 1% | | | |
| ** Significant at 5% | | | |

The results of the GLS regression on the return on equity (ROE) are presented in Table 3. Generally, the results are quite similar to the results on the return on asset (ROA) where institutional ownership has a significant negative relationship on the ROE. In addition, composition of independent non-executive directors has a significant influence on the ROE; however, its sign of relationship contradicts the expectation. Finally, size of the banks and better economic environment (i.e. higher GDP rate) and firm size (i.e. LNTA) influence higher profitability by the banks.

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4.4 Summary of Findings

Summary findings of the impact of corporate governance on profitability can be referred to Table 4.

Table 4: Summary Results of Profitability

| | | Profitability | |
|-----------------------|--|---------------|---------|
| | | ROA | ROE |
| Independent variables | | | |
| BLS | Sign as predicted in the hypothesis Significant level | √ - | √ - |
| INE_BZ | Sign as predicted in the hypothesis Significant level | X - | X 5% |
| BZ | Sign as predicted in the hypothesis Significant level | √ - | √ - |
| DOWN | Sign as predicted in the hypothesis Significant level | X - | X - |
| IOWN | Sign as predicted in the hypothesis Significant level | X 1% | X 1% |
| BOWN | Sign as predicted in the hypothesis Significant level | X - | X - |

Separate leadership structure seems to have higher profitability in this research. Fosberg and Nelson (1999), Rashidah and Roszaini (2005), Chen et al. (2005), Chiang (2005), Feng, Ghosh and Sirmans (2005), Roszaini and Mohammad (2006) and Coleman, Adjasi and Abor (2007) have previously found similar results as to the findings of this study. These researchers have also used ROA and ROE as proxies for profitability. The findings of this research show that higher ratio of independent directors on the board seems to have lower profitability. Based on the prior research, the findings of Othman (2003) in Vethanayagam, Sofri and Hasnah (2006) show that there is a negative relationship between ratio of independent directors to the board and profitability, where return on assets is used as a proxy. Smaller board size seems to have higher profitability. The findings are consistent with the findings of Feng, Ghosh and Sirmans (2005) and Cheng (2008).

With regard to the ownership structure variables, none is significant as hypothesized. However, the significance of the institutional ownership variable is consistent in all regression models although the relationship is negative. The negative relationship between profitability and institutional ownership is supported by the previous research of Berger, Hasan and Zhou (2005) and Barako and Tower (2007) where they found that more ownership by the government leads toward lower profitability.

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Barako and Tower (2007) utilize government ownership as a proxy for institutional ownership and they find that there is a negative relationship between institutional ownership and profitability, where profitability is measured by return on equity and ratio of non-performing loans to total loans. Finally block ownership is found to be insignificant in this research. Based on the findings in this research, the board composition and ownership variables are not in line with theoretical expectation. The possible reasons not being in line with what have been hypothesized are explained in the following paragraphs.

With regard to the board composition, the mean value of ratio of independent directors to the board is 0.35 and hence, only 35 percent of the board members are independent which means that companies are just meeting the recommendation by the MCCG (2001). Based on the corporate governance literature, the higher the number of independent directors on the board, the more independent it is from the management and the higher profitability of the company. However, the literature does not ignore the important role of the executive directors on the board. Therefore, in general, it could be concluded that the number of independent directors on the board should be relatively low in order for the board to make independent decision. Secondly, according to Leng and Shazaili (2005), non-executive directors in Malaysia are not really independent enough to play a serious monitoring role and they may not be of high caliber to contribute significantly to firm profitability. Finally, the independent directors perform little role in monitoring the management because of lack of time due to multiple directorship. Hence, the existing outside directors who hold other directorships in different companies might be busy and they are not able to concentrate to achieve higher profitability of the firms. Findings of Fich and Shivdasani (2006) show that busy outside directors are likely to lead to poor performance of the firms. Furthermore, Roszaini and Mohammad (2006) mention that multiple directorships is common in Malaysia and it might cause the negative effects on profitability due to competitive disadvantages, potential conflicts of interest as well as less commitment if they are too busy attending board meetings. The above discussions provide some possible explanations for an ineffective monitoring by non-executive directors from previous literature and thus provide opportunities for future research.

With regard to the ownership structure, the directors own only 2.22% of shares. Thus, director ownership is insignificant to influence the board decision-making process. In case of institutional ownership, most of them come from the government agencies, and therefore it might result in less effectiveness in monitoring the management. Corporate governance literature has highlighted the ineffectiveness of the monitoring role of the government ownership towards the management (Patibandla 2006). Many researchers such as Brouters, Gelderman and Arens (2007) find the ineffective role of government as an institutional owner. In addition, based on the Report of Asian Productivity Organization (2007), the institutional shareholders in Malaysia are still considered weak. Regarding block ownership, on the average, 53 percentage of ownership belongs to the block ownership and hence, it seems that block ownership has substantial ownership interest which motivates them to monitor the management. However, based on the results, they do not seem to play their role. Future research might need to look into this issue.

5. Conclusion

The objective of this paper is to examine the impact of corporate governance on profitability of Malaysian listed banks and thus, the alternative hypothesis is developed based on the agency theory and it is found that only board leadership structure and board size are in line with the hypothesis and the rest are not. It might be due to the fact that agency theory represents an attractive platform for structuring corporate governance systems and it seems to be Anglo-American centric and insensitive to non-economic forces that drive managerial choices in mixed (socialist/capitalist) economies. Hence, it could be concluded that corporate governance systems are not converging (Yoshikawa & Phan 2003) and local laws and business environment might influence the governance system in its own country (Seifert, Gonenc & Wright 2005). Furthermore, the traditional view argues that governance systems are different between Anglo-American countries and other countries. Therefore, it can be inferred that it is difficult to conclude which governance system is the best since it depends on the needs and cultures of the companies, political situations, local prevailing laws and business environment.

However, the significance of the institutional ownership variable in all the three models raises an interesting concern, though; its significance is in an opposite direction. These results confirm that the role of institutional shareholders in Malaysia is still very weak, as more ownership by the institutional shareholders lead to a lower profitability by the banks. This provides an opportunity for future research to examine the effectiveness of institutional shareholders in their monitoring roles within the corporate governance framework.

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