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Unlocking Value: The Mediating Role of Corporate Governance on the CSR-Performance Link in the Banking Sector of Pakistan

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Abstract

The main objective of this research manuscript is to examine the mediating role of corporate governance on the relationship between the corporate social responsibility on Islamic and conventional banks' performance. The two performance indicators are analyzed in this study. The first one is financial stability, and the second one is profitability. The data for this study is obtained from the financial statements of the banks for the period of 2010 to 2022. The research has used Principal Component Analysis (PCA) to construct a corporate governance index. We have applied descriptive statistic, correlation analysis, diagnostic analysis, and dynamic generalized method of moments (GMM) models to find and examine the relationships among variables. The findings show that corporate social responsibility has strong positive influence on the banks' profitability and corporate governance mediates this links. The study's results are useful for investors, scholars, government regulators, and business professionals who want to know how corporate governance, company investments, corporate social responsibility, and business performance are connected.

Keywords- Corporate Governance, Islamic Banks, Conventional banks, Corporate Social Responsibility, performance.

Introduction

Corporate governance and its relationship with firm performance, keep on being an integral part of empirical as well as theoretical study in corporate studies. Corporate governance has gotten a lot of attention and developed as an essential instrument over the last decades. The improvement of corporate governance mechanisms has been reinforced due to the recent global financial crisis, fast growth of privatizations and financial institutions development (Latif, Latif & Abdullah (2017). According to Cadbury (1992) Corporate governance is like the rulebook for how a company is run. It includes how decisions are made, who's in charge, and how everyone works together (Mallin, 2016). The main aim is to make sure shareholders are taken care of and that the company runs honestly and openly (Ayuso et al, 2014). Studies also look at how the way companies are managed affects how well they do (Arora and Shrama, 2016). Researchers want to know how companies that are run well, with good rules and structures, tend to do in business (Malik and Makhdoom, 2016). This research helps us see why having good rules in place is

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important for companies to succeed. Good corporate governance helps cut down on problems like conflicts between bosses and shareholders and helps the company grow and do well over time. (Farag, Mallin, & Ow-Yong, 2018). Corporate governance improved the performance of a firm by improving the company's image, reducing the risk of fraudulent activities and increasing the shareholders' confidence (Latif & Abdullah 2015).

Carroll (1979) stated that organizations utilizing society's resources must engage themselves in social responsibility and philanthropic activities for the well-being of that society. Freeman (1984) highlighted the benefit of corporate social responsibility by stating that socially responsible activities of a company give it a competitive edge in the market. In the modern world of global competition, businesses need to balance and harmonize value creation with sustainable development (Ntanos, Kyriakopoulos, Chalikias, Arabatzis, Kordoulis, Galatsidas, & Drosos 2018). This is because the public expects businesses to take social, environmental, and economic responsibility into account when making decisions (Barauskaite & Streimikiene, 2020). Therefore, public disclosure is imperative for all the activities of a company, particularly in industries where the influence on society and the environment is larger and positive, to acquire a competitive advantage (Escamilla-Solano, Plaza-Casado & Flores-Ureba, 2016). The global standards for nonfinancial information disclosure have been steadily increasing in recent years. Most importantly, the establishment of standards for the public disclosure of nonfinancial information at the European level through the directive 95/2014/EU has revolutionized the way businesses declare their CSR activities (Cupertino, Vitale & Taticchi (2023). The European directive about corporate social responsibility (CSR) has made businesses more transparent. It tells companies to share lots of details about what they're doing to help society and the environment (De Schutter, 2008). This rule makes companies more accountable and helps build trust with everyone involved, like investors, customers, and local communities (Öberseder, Schlegelmilch, & Murphy, 2013). Because of this, people can learn more about a company's good deeds and decide if they want to support them. It also means companies have to be careful about how they impact society and the environment (Epstein & Yuthas, 2013).

According to Miotto & Vilajoana-Alejandre (2019) utilizing sustainability reports has become a norm for determining how involved a company is with its stakeholders. Reducing the gap between managers and investors through firm disclosure fosters user trust and offers numerous benefits to the company, including lower capital costs, higher stock valuations, increased stock liquidity, and increased interest from institutional investors (Cormier & Magnan, 2003). Regarding the connection between CSR disclosure and firm performance, research is equivocal. Few studies such as Xie & Zhan (2023), Jaisinghani & Sekhon (2020); and Platonova, Asutay, Dixon & Mohammad (2018) have found strong positive association between corporate social responsibility and firm performance while others such as Chen, Hung, & Wang (2018) and Fahad & Busru (2021) found negative link between corporate social responsibility and firm performance. Some other research studies suggest that doing good things for society, called corporate social responsibility (CSR), might actually hurt a company's performance (Selcuk & Kiymaz, 2017: Bhattacharyya & Khan, 2023). They say that spending money on CSR could take

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away from making profits, making the company earn less money (Sial et al, 2018). Also, some people argue that even if a company does good things, it might not always make more money because of it (Anderson, Hyun & Warsame, 2024). But it's important to know that how CSR affects a company can change depending on things like what industry it's in, where it's located, and what specific things it does for CSR (Jang et al, 2019).

Recently, an increasing body of research is focusing on examining the part that various firm attributes play in this relationship as well as company time of life (Qazi & Aspal, 2021), institutional possession (Lu & Abeysekera, 2021), board independence (Karim et al., 2020), firm size (Gallardo-Vázquez, Barroso-Mendez, Pajuelo-Moreno & Sanchez-Meca (2019) macroeconomic indicators (Al-Dah, Dah & Jizi (2018). In the 20th century, there was a discussion about whether firms should adopt CSR policies and whether they should be obligatory or optional. However, in the 21st century, CSR has become widely accepted and integrated into all aspects of society. CSR is loomed using a multidisciplinary approach, aiming to achieve a balance between the social, environmental, and economic goals of the company. This approach has gained widespread acceptance in the scientific community (De la Cuesta & Valour, 2004; EscamillaSolano et al., 2016) (Garriga & Mele, 2004) (Székely & Knirsch, 2005).Past literature shows that CSR plays in important role in firm performance and corporate governance plays pivotal role in managing the firm's operations (Sial et al, 2018: Epstein, 2017). We did not find any specific work done previously to find the mediating role of corporate governance on the CSR-performance link in the banking industry, most of the studies were associated to oil industry, airlines, and private companies (Lee, Seo, & Sharma, 2013: Kiran, 2015).

Therefore, we attempt to fill this gap in the literature and try to find that whether corporate governance has any impact on the relationship between CSR and banking sector's financial stability and performance (performance indicators). This study looks at how companies run themselves, focusing on how they balance the interests of managers and shareholders. It uses a theory called agency theory, which says that good governance helps prevent conflicts between these groups. In the case of corporate social responsibility (CSR) and how well a company does, agency theory suggests that when companies have strong governance, they tend to do better because they make decisions that benefit everyone involved. The study focuses on banks in Pakistan to see how governance affects the relationship between CSR efforts and how well the bank performs. It aims to show how governance practices can make CSR efforts more effective.

Hypotheses of the Study

To fulfill the objectives of this study, the following hypotheses are drawn.

H_1: There is a positive relationship between corporate social responsibility and financial stability of the banking sector.

H_2: There is a positive relationship between corporate social responsibility and the profitability of the banking sector.

H_3: Corporate governance plays a mediating role in CSR-financial stability link in the banking sector.

H_4: Corporate governance plays a mediating role in CSR-profitability link in the banking sector.

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Theoretical Framework

The aim of this study is to find the mediating role of corporate governance on the CSR-performance link in the banking industry of Pakistan. The theoretical framework is as follows for this study:

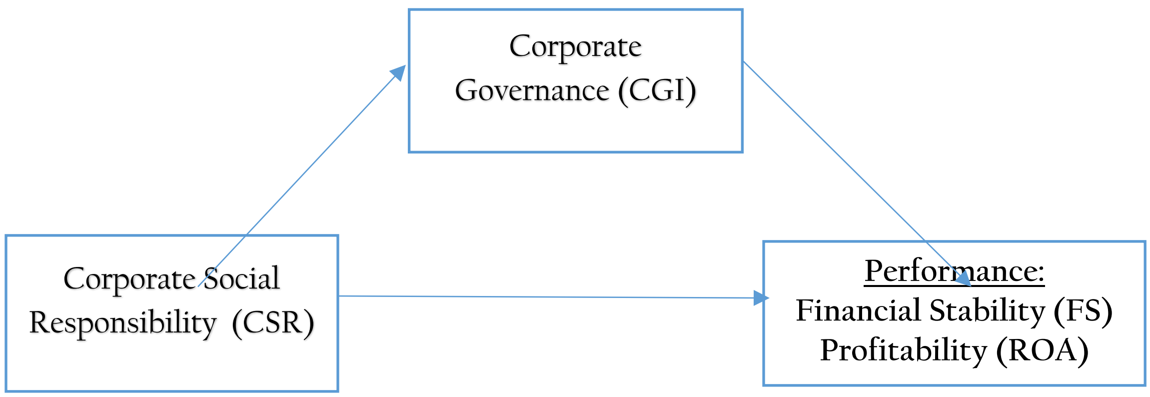

Figure 1: Theoretical Framework

Research Methodology

The sample for this study consists of 18 commercial banks of Pakistan. We collected the data from the financial reports of the selected banks over the period of 2010 to 2022. A two-step system generalize method of moment estimation is used to test the hypotheses on the relationship among the mediating role of corporate governance on the link between corporate social responsibility and the financial stability and profitability. We used GMM estimation tool to estimate the relationship among the variables. The benefit of the GMM tool is to control the problem of endogeneity in the models as proposed by Arellano and Bover (1995). Following Anarfo, Abor, Osei, & Gyeke-Dako (2019) dependent variable financial stability is measured through the Z-Score index. For banks' profitability we followed Li, Wu, & Sun (2021) and measured it through return on assets (ROA). Following Pyo & Lee (2013) we measured CSR as the natural log donations made by the company.

Statistical Models:

The GMM estimation technique

$$\mathrm{FS_{it}} = \beta + \beta_1 FS_{it-1} + \beta_2 \mathrm{CSR_{it}} + \beta_3 \mathrm{CGI_{it}} * \mathrm{CSR_{it}} + \beta_4 \mathrm{Size_{it}} + \beta_5 \mathrm{Age_{it}} + \varepsilon_{\mathrm{it}} \qquad 01$$

$$\mathrm{ROA_{it}} = \beta + \beta_1 ROA_{it-1} + \beta_2 \mathrm{CSR_{it}} + \beta_3 \mathrm{CGI_{it}} * \mathrm{CSR_{it}} + \beta_4 \mathrm{Size_{it}} + \beta_5 \mathrm{Age_{it}} + \varepsilon_{\mathrm{it}} \qquad 02$$

$$ROE_{it} = \beta + \beta_1 ROE_{it-1} + \beta_2 \mathrm{CSR_{it}} + \beta_3 \mathrm{CGI_{it}} * \mathrm{CSR_{it}} + \beta_4 \mathrm{Size_{it}} + \beta_5 \mathrm{Age_{it}} + \varepsilon_{\mathrm{it}} \qquad 03$$

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Variables Measurements

Table 2.1: Variables Measurements

Models	Variables names	Symbol	Measurement
1	Financial Stability	Z-Score	Z-score Index
2	Profitability	ROA	Net income/total asset
3	Profitability	ROE	Net income/total equity
4	Corporate Social Responsibility	CSR	Natural log of Donations
5	Corporate Governance	CGI	Number of board members, CEO duality and board independence
6	Bank Size	Size	The natural log of the total asset
7	Bank Age	Age	Number of operating years

Results and Discussion

Following is presented the result of statistical analysis of the data.

Descriptive Analysis

Table 3.1: Descriptive Statistics

Variables	Mean	Median	SD
FS	0.0893	0.9900	1.089
ROA	0.0592	0.0692	0.0784
ROE	0.0254	0.0754	0.0584
CGI	0.0341	0.0380	0.9870
CSR	1.3900	1.5609	1.7890
Size	19.0913	20.940	7.9030
Age	21.0291	22.904	8.7040

Descriptive results show that the mean values of FS, ROA, ROE, CGI, CSR, Size and Age are 0.0893, 0.0592, 0.0254, 0.0341, 1.390, 19.091, 21.0291.

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Correlation Analysis

Table 3.2: Correlation Matrix

Variables	1	2	3	4	5	6	7
FS	1						
ROA	0.254	1					
ROE	0.039	0.211	1				
CSR	0.491	0.392	0.421	1			
CGI	0.192	0.374	0.562	0.261	1		
Size	0.037	0.155	0.257	0.059	0.059	1	
Age	0.029	0.061	0.058	0.059	0.063	0.069	1

Table 3.2 shows that CSR is positively significant associated with the financial stability and profitability of the banks. This shows that increase in CSR increase stability and profitability of the banks in Pakistan. Moreover, Table 3.2 shows that CGI has a positive coefficient with the CSR though the magnitude of the coefficient is small. CGI is also found to have a positive association with the financial stability and profitability of the banks. Size of banks is found to have positively significant association with the profitability though such a relation is not found with the stability of the banks. Age of the banks have positive but low magnitude association with the stability and profitability of the banks of Pakistan.

GMM Estimation

Table 3.3: GMM Estimation

Variables	GMM SYS-FS	GMM SYS-ROA	GMM SYS-ROE
FS_{it-1}	0.482*** (0.3821)	---	---
ROA_{it-1}	---	0.239*** (0.4620)	---
ROE_{it-1}	---	---	0.321*** (0.1001)
CGI*CSR	0.178** (0.182)	0.573*** (0.410)	0.382*** (0.0473)
CSR	0.062** (0.342)	0.321*** (0.342)	0.321*** (0.213)

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Size	0.037* (0.047)	0.0475** (0.046)	0.057** (0.072)
Age	0.0483** (0.057)	0.0127 (0.451)	0.058 (0382)
Constant	0.220*** (0.114)	0.305*** (0.065)	0.108*** (0.102)
P-Sargan	0.825	1.000	0.996
Observations	245	245	245

Note: Robust t-statistics in parentheses
***, **, * indicates significance at 1%, 5% and 10% respectively.

Table 3.3 shows that corporate social responsibility has a positive and significant link with the financial stability and profitability of the banks. Table also shows that corporate governance plays a mediating role and found significant with both financial stability and profitability. These finding s are consistent with the finding of Barauskaitė & Štreimikienė (2020), Elouidani, & Zoubir (2015) and Okegbe & Egbunike (2016). Size of the banks is found to have positive relationship with the financial stability and profitability while age of the banks if found to have positive relation with only financial stability.

Conclusion

The research endeavored to examine the impact of mediating role of corporate governance on the link between corporate social responsibility and performance of banking sector in Pakistan. The performance is measured through two different indicators which are: financial stability and profitability. Sample consisted of 18 commercial banks of Pakistan. While data span from 2010-2022. Data was analyzed through the descriptive statistics and correlation analysis. Different diagnostics tests were applied like heteroskadiscity, multicollinearity, stationarity, and endogeneity. The GMM estimation was utilized to estimate the relationship between variables. The primary advantage of the Generalized Method of Moments (GMM) is its ability to address the issue of endogeneity in models. This study found that corporate social responsibility has a positive impact on the financial stability and profitability of commercial banks in Pakistan. Secondly, the research found that corporate governance create link between the corporate social responsibility and financial stability and profitability. The research has significant implication for the financial and non-financial institutions, investors and policymakers that can utilize these findings to achieve optimum performance.

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