Factors Affecting Corporate Governance on Financial Risk of Nepalese Commercial Banks

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ABSTRACT

This study examines the impact of corporate governance on the financial risk of Nepalese commercial banks over the period from 2015/16 to 2023/24. Non-performing loans (NPL) and cash reserve ratio (CRR) are selected as the dependent variables, while the independent variables include board size, audit committee, ownership structure, leverage, board independence, and foreign capital. The study is based on secondary data from 20 commercial banks, totaling 140 observations. The data were sourced from the Nepal Rastra Bank, Nepal Stock Exchange (NEPSE) Limited, and the Securities Board of Nepal (SEBON) website. Correlation coefficients and regression models were employed to assess the relationship between corporate governance and financial risk in Nepalese commercial banks. The findings reveal that board size, board independence, and foreign capital have a positive relationship with non-performing loans, indicating that as these factors increase, financial risk also rises. Conversely, audit committee effectiveness, ownership structure, and leverage are negatively associated with non-performing loans. Additionally, the study shows that board size, audit committee, ownership structure, leverage, and board independence positively influence the cash reserve ratio, while foreign capital exhibits a negative relationship with CRR.

Keywords: Board size, board independence, ownership structure, leverage, foreign capital, audit committee.

INTRODUCTION

Corporate Governance refers to the system of rules, practices, and processes by which a company is directed and controlled (OECD, 2004). The banking system plays a pivotal role in any economy, making corporate governance and risk management critical components of financial institutions. The relevance of corporate governance was highlighted during the 1997-1998 Asian financial crises, which underscored the need for strong governance frameworks to prevent market failures and economic downturns. In Nepal, the banking sector's significance has grown considerably over the years, necessitating a closer examination of the impact of corporate governance on financial risks. This study aims to analyze how variables such as board size, audit committee, ownership structure, leverage, board independence, and foreign capital influence the financial risk of Nepalese commercial banks during the period 2015/16 to 2023/24.

Thematic Literature Review

Corporate Governance and Financial Risk: Conceptual Understanding

Ayorinde et al. (2012) conceptualize corporate governance as a system designed to build credibility, ensure transparency, and maintain effective channels of information disclosure to foster good corporate performance. Corporate governance structures influence a firm’s risk-taking behavior and its overall financial health.

Board Structure and Financial Risk

Board size, composition, and independence have been extensively studied as corporate governance factors influencing financial risk. Salhi and Boujelbene (2012) analyzed data from 10 Tunisian banks over eight years

(2002–2009) and concluded that smaller board sizes reduce risk-taking activities. Tsorhe et al. (2011) explored board independence, suggesting that the proportion of outside members enhances independence, but found no significant impact on capital, credit, or liquidity risk. Bhattarai (2017) found that board size negatively impacts financial risk in Nepalese commercial banks, while the presence of independent directors positively impacts financial risk. Chand (2020) revealed a negative relationship between board size and return on equity, indicating its role in reducing financial risk.

CEO Duality and Financial Risk

Grove et al. (2011) found that CEO duality (when the CEO is also the board chair) has a negative association with financial risk, suggesting a potentially beneficial role in certain contexts.

Board Diversity and Composition

Shungu et al. (2014), in a study on Zimbabwean banks, found that board composition and diversity have a positive relationship with financial risk, indicating that diverse boards may take on more risk.

Audit Committees and Governance Structures

Poudel & Hovey (2012) found that larger audit committee size and lower board meeting frequency have a positive relationship with financial risk in Nepalese banks. Bhattarai (2017) similarly observed that audit committee size positively impacts financial risk.

Ownership Structure

Poudel & Hovey (2012) also found that lower institutional ownership is associated with higher financial risk. Chaudhary (2020) identified that concentrated ownership is positively associated with financial risk.

Leverage and Financial Risk

Grove et al. (2011) reported a negative association between leverage and both financial risk and loan quality.

Corporate Governance in the Nepalese Context

Multiple studies have addressed the impact of corporate governance on financial risk in Nepal: Subedi & Neupane (2013) found that corporate governance is positively related to capital risk. Acharya (2018) and Pradhan et al. (2019) both concluded that corporate governance has a statistically positive effect on financial and non-performing loan (NPL) risks. Chaudhary (2020) also observed a positive relationship between board size and financial risk in Nepalese commercial banks.

The above discussion showed that the studies dealing with factors of corporate governance on financial risk are of greater significance. Hence, this study attempts to analyze the impact of corporate governance on financial risk of Nepalese commercial banks. Though there are above mentioned empirical evidences with thematic reviews in the context of other countries and in Nepal, no such findings using more recent data exist in the context of Nepal. Therefore, to support one view or the other, this study has been conducted.

The main purpose of the study is to examine the factors affecting the of corporate governance on financial risk of Nepalese commercial banks. Specifically, it examines the relationship board size, audit committee, ownership structure, leverage, board independence, and foreign capital with non-performing loan and cash reserve ratio of Nepalese commercial banks.The remainder of this study is organized as follows. Section two describes the sample, data, and methodology. Section three presents the empirical results and the final sections draws conclusion and discusses the implications of the study findings.

Conceptual Framework

The conceptual framework ties governance features such as board independence, ownership structure, audit committee, leverage, board size and foreign capital function to indicators of credit risk like NPL ratios and cash reserve ratio. A visual diagram can aid in understanding these interactions and guide empirical testing.

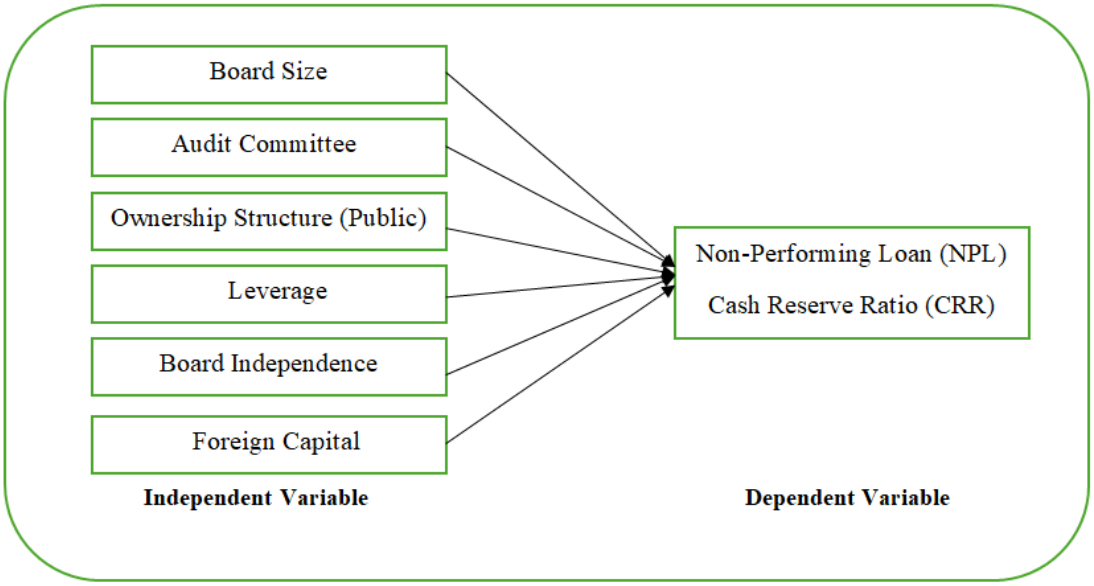

Figure: 3.1 Conceptual Framework

Methodological aspects

The study is based on the secondary data which were gathered from 20 Nepalese commercial banks from 2015/16 to 2023/24, leading to a total of 180 observations. The main sources of data include publications and websites of Nepal Rastra Bank (NRB), Ministry of Finance (MoF), and annual reports of the selected commercial banks. This study is based on descriptive as well as causal comparative research designs. Table 1 shows the list of commercial banks selected for the study along with the study period and number of observations.

Table 1: List of commercial banks selected for the study along with study period and number of observations

S.N.	Name of the Banks	Study Period	Observations
1	Agricultural Development Bank Limited	2015/16-2023/24	9
2	Nabil Bank Limited	2015/16-2023/24	9
3	Global IME Bank Limited	2015/16-2023/24	9
4	Rastriya Banijya Bank Limited	2015/16-2023/24	9
5	Civil Bank Limited	2015/16-2023/24	9
6	Himalayan Bank Limited	2015/16-2023/24	9
7	Kumari Bank Limited	2015/16-2023/24	9
8	Laxmi Sunrise Bank Limited (	2015/16-2023/24	9
9	Machhapuchchhre Bank Limited	2015/16-2023/24	9

10	Mega Bank Nepal Limited	2015/16-2023/24	9
11	Sanima Bank Limited	2015/16-2023/24	9
12	Nepal Bank Limited	2015/16-2023/24	9
13	Nepal SBI Bank Limited	2015/16-2023/24	9
14	Siddhartha Bank Limited	2015/16-2023/24	9
15	NIC Asia Bank Limited	2015/16-2023/24	9
16	Everest Bank Limited	2015/16-2023/24	9
17	Prabhu Bank Limited	2015/16-2023/24	9
18	Bank of Kathmandu Limited	2015/16-2023/24	9
19	Nepal Credit and Commerce Bank Limited	2015/16-2023/24	9
20	Machhapuchchhre Bank Limited	2015/16-2023/24	9
		Total	180

The model

The model used in this study examine the factors affecting of corporate governance on financial risk of Nepalese commercial banks. The dependent variables selected for the study are non-performing loan and cash reserve ratio. Similarly, the selected independent variables in this study are board size, audit committee, ownership structure, leverage, board independence, and foreign capital. The following model equations are designed to test the hypothesis.

Model:1

$$NPL_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 AC_{it} + \beta_3 OS_{it} + \beta_4 LEV_{it} + \beta_5 BI_{it} + \beta_6 FC_{it} + e_{it}$$

Model:2

$$CRR_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 AC_{it} + \beta_3 OS_{it} + \beta_4 LEV_{it} + \beta_5 BI_{it} + \beta_6 FC_{it} + e_{it}$$

Where,

NPL = Nonperforming loan as measured by the ratio of total equity to total assets, in percentage.

CRR = Cash reserve ratio as measured by reserve requirement to bank deposits, in percentage.

BS = Size of board, in number.

AC= Audit committee measured as return on assets (ROA), in numbers.

OS= Ownership structure measured as the number of shares of common stock, in percentage.

LEV = Leverage as measured as total debt to total equity, in times.

BI =Board independence measured as number of independent directors to total directors on the board, in numbers.

FC = Foreign capital measured as capital of investor from foreign, in percentage.

Justification for Model Selection

The study employs a panel data approach to account for both cross-sectional (across different banks) and temporal (over time) variations. The benefits of using panel data include:

- Increased variability: Panel data provides a broader range of observations, helping to capture both differences between banks and trends over time.
- Efficiency: The use of panel data enhances the efficiency of statistical estimates, making the results more reliable compared to using only cross-sectional or time-series data.
- Control for unobserved heterogeneity: Panel data helps to control for unobserved factors that vary across banks but remain constant over time.

Model Estimation

To estimate the relationship between corporate governance and financial risk, both Fixed Effects (FE) and Random Effects (RE) models are considered. The choice between these models is determined using the Hausman test. If the test suggests that the Fixed Effects model is more appropriate, it will be used to control for time-invariant characteristics of the banks that may affect the dependent variables.

Diagnostic Tests

To ensure the robustness of the results, several diagnostic tests are performed:

- Multicollinearity: VIF results were all under 5, indicating no major multicollinearity issues.
- Autocorrelation: Durbin-Watson values ranged between 1.8 and 2.2, showing acceptable limits.
- Homoscedasticity: Residual plots confirmed consistent variance without heteroscedasticity.

The following section describes the independent variables used in this study along with hypothesis formulation.

Board size

Board size has impact on supervision, management, and consultation capacities of managers. Lipton and Jay (1992) showed that a smaller board size works more effective since a larger board and has a positive relationship with financial risk. However, Pearce, and Zahra (1992) suggested a larger board size will strengthen capacity to supervise and improve information sources and also explored that it has a positive impact with financial risk. Pathan *et al*. (2007) found that there is significant negative relation between board size and financial risk. Katuse *et al.* (2013) suggested that there is positive significant relationship of board size with financial risk. Manini and Abdillahi (2015) concluded that board size negatively influences financial risk. Isik and Ince (2016) explored that board size has a significantly positive effect on bank's financial risk. Sarkar and Sarkar (2018) showed that board independence and board size have significant positive correlation with the financial risk. Likewise, Oyedokun (2019) revealed that board size has an insignificant negative effect on financial risk. Based on it, this study develops the following hypothesis:

H_1: There is a positive relationship between board size and financail risk.

Audit committee

Audit committee may have impact on the risk level of company to a noticeable degree. Because one of main responsibilities of audit committee is supervise the integrity of financial statements, internal auditing and risk management. Beasley (1996) found evidence that audit committee does not have positive relationship with

financial risk. Tsorhe *et al.* (2011) showed that audit committee does not statistically significantly impact on financial risk. A study conducted by Klein (2002) and Coleman-Kyereboah (2007) revealed positive relationship between audit committee size and a financail risk. However, Hardwick *et al.* (2003) and Kajola (2008) reported no positive relation between audit committee's size and financial risk. Al-Matari *et al*. (2014) found that audit committee has a positive and significant relationship with banks financial risk. Chou (2017) revealed that audit committee has a positive impact on financial risk. Based on it, this study develops the following hypothesis:

H_2: There is a positive relationship between audit committee and financail risk.

Public Ownership structure

Ownership structure is also a critical determinant of corporate governance. Capital structure relates to foreign capital, state-owned capital, majority shareholders. Consequently, capital proportion of foreign investors may represent for an ownership factor of internal governance. Kalluru (2009) found that ownership structure is negatively associated with bank risk. Barry *et al.* (2011) showed that ownership structure has a positive significant relationship with financial risk of banking sector. Kapur & Gualu (2012) revealed that ownership structure has a positive relationship with financial risk. Likewise, Chege (2013) showed that ownership structure has a positive impact on corporate financial risk. Similarly, Pound (1988) showed that ownership has no positive impact with financial risk. Chaganti & Damanpour (1991) and Han & Suk (1998) noted positive link between ownership structure and financial risk but, in contrast, Craswell *et al.* (1997) found negative relationship with financial risk. Based on it, this study develops the following hypothesis:

H_3: There is a positive relationship between ownership structure and financial risk.

Leverage

Leverage results from using borrowed capital as a funding source when investing to expand the firm's asset base and generate returns on risk capital. Wabwile *et al*. (2014) found that there is a negative relation between market value to book value ratio and the firm's financial leverage. Leverage ratio is also known as debt ratio or financial leverage ratio or debt to total assets ratio that indicates the percentage of assets that are being financed with debt. Myers & Majluf (1984) stated that firms use debt only when the internal financing is not available and argued against the existence of target capital structure. Debt financing sources may also exert different effects on managerial incentives and resolve moral hazard issues. In addition, when ownership and control over a firm is diluted, managerial optimality rather than shareholders optimality should be considered (Zwiebel, 1996). Berger and Di Patti (2006) found that there is a positive relationship between debt asset ratio and financial risk. Similarly, Ahmad *et al.* (2015) concluded that there is a significant negative relationship between financial leverage (total debt to total assets) and the finanacail risk of the firm. Likewise, Birru (2016) showed that there is a negative impact of debt ratio on finanacail risk. Sivalingam and Kengatharan (2018) asserted that total debt to total assets ratio is negatively significant with financial risk and total debt to total assets ratio was negatively significantly with financial risk. Sheel (1994) observed negative relation between debt to assets ratio and firms past financail risk. Datta and Mahmud (2018) revealed that there is a negative relation between debt to asset and financail risk. Based on it, this study develops the following hypothesis:

H_4: There is a positive relationship between leverage and financail risk.

Board Independence

Board independence is very important to efficiently monitor the managers and minimize the agency cost because independent director on board have better controlling and monitoring for the opportunistic activities of the management. Choe & Lee (2003) revealed that there is positive of board independence on financail risk. Likewise, Zahra & Pearce, (1989) found that board independence is positively related with financail risk. 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 in the board to add the fresh ideas, independence, objectivity and expertise gained from their own fields (Choe & Lee, 2003). Considering the importance of independent director on board, Nepalese bank should appoint one independent

director from the professional bodies prescribed by central bank of Nepal. Some researchers Baysinger & Butler (1985) and Ezzamel & Watson (1993) found outside directors are positively related with a finanacail risk whereas Wen *et al.* (2002) and Brick & Chidambaran (2008) observed the negative result between board independence and a financial risk. In different direction, Kajola (2008) found no any significant relationship between board independence and firm financail risk in the Nigerian listed firms. Based on it, this study develops the following hypothesis:

H_5: There is a positive relationship between board independence and financial risk.

Foreign capital

The term 'foreign capital' is a comprehensive term and includes any inflow of capital in home country from abroad. It may be in the form of foreign aid or loans and grants from the host country or an institution at the government level as well as foreign investment and commercial borrowings at the enterprise level or both. Salhi and Boujelbene (2012) indicated that the participation of foreign investors has a positive impact on the credit risk management. Zhong *et al.* (2021) found that foreign capital has positive impact on financail risk. Ahmed *et. al*. (2015) showed that foreign exchange exposure has negative effect on the financial risk. Likewise, Patora (2016) revealed that foreign capital and liquidity have positive relationship with financial risk of banking sectors. Saif-Alyousfi *et al.* (2017) explored that foreign capital has a positive significant relationship with the financial risk. Xu (2018) found that foreign capital has a positive significant relationship with the financial risk. Kukaj *et al.* (2020) assessed foreign capital has a positive significant relationship with the financial risk. d commercial bank in Kenya. Based on it, this study develops the following hypothesis:

H_6: There is a negative relationship between foreign capital and financail risk.

RESULTS AND DISCUSSION

Descriptive statistics

Table 2 shows the descriptive statistics of dependent and independent variables of 20 Nepalese commercial banks for the study period from 2015/16 to 2023/24. The dependent variables are NPL (Nonperforming loan as measured by the ratio of total equity to total assets, in percentage) and CRR (Cash reserve ratio as measured by reserve requirement to bank deposits, in percentage). The independent variables are BS (Size of board, in numbers), AC (Audit committee measured as return on assets, in numbers.), OS (Ownership structure measured as the number of shares of common stock, in percentage), LEV (Leverage as measured as total debt to total equity, in times), BI (Board independence measured as number of independent directors to total directors on the board, in numbers) and FC (Foreign capital measured as capital of investor from foreign, in percentage).

Table 2: Descriptive statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
Non-Performing Loans (NPL)	0.05	10.25	1.8	2.2
Cash Reserve Ratio (CRR)	3	35	13.5	8.9
Board Size (BS)	6	12	7.8	1.3
Audit Committee (AC)	2	6	3.2	0.7
Ownership Structure (OS)	20	95	62.5	24.5
Leverage (LEV)	0.1	4	1	0.5
Board Independence (BI)	0.1	1	0.88	0.3

Foreign Capital (FC)	0	85	12	20

(Source: SPSS output)

Correlation Analysis

Table 3 shows the bivariate Pearson's correlation coefficients of dependent and independent variables of 20 Nepalese commercial banks for the study period from 2015/16 to 2023/24. The dependent variables are NPL (Nonperforming loan as measured by the ratio of total equity to total assets, in percentage) and CRR (Cash reserve ratio as measured by reserve requirement to bank deposits, in percentage). The independent variables are BS (Size of board, in numbers), AC (Audit committee measured as return on assets, in numbers.), OS (Ownership structure measured as the number of shares of common stock, in percentage), LEV (Leverage as measured as total debt to total equity, in times), BI (Board independence measured as number of independent directors to total directors on the board, in numbers) and FC (Foreign capital measured as capital of investor from foreign, in percentage).

Table 3: Pearson's correlation coefficients matrix

Variables	**NPL**	**CRR**	**BS**	**AC**	**OS**	**LEV**	**BI**	**FC**
NPL	1							
CRR	-0.150*	1						
BS	0.065	0.220**	1					
AC	-0.255**	0.295**	0.310**	1				
OS	-0.085	0.01	-0.14	-0.12	1			
LEV	-0.04	0.025	0.155	0.06	0.190*	1		
BI	0.05	0.13	0.085	0.02	-0.07	0.015	1	
FC	0.01	-0.165	-0.08	-0.500**	-0.230*	-0.12	-0.06	1

(Source: SPSS output)

Note: The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent levels respectively.

Table 3 shows a positive relationship between board size and NPLs, indicating that larger boards tend to have higher non-performing loans. This can be attributed to inefficiencies and coordination challenges within larger boards, which may weaken accountability and oversight, leading to riskier lending practices and an increased likelihood of defaults. On the other hand, the negative relationship between the audit committee and NPLs suggests that a more active and effective audit committee helps reduce non-performing loans. A strong audit committee improves oversight and enhances risk management, leading to more effective identification and mitigation of risky loans.

The negative relationship between ownership structure and NPLs suggests that banks with concentrated ownership structures are less likely to have non-performing loans. Concentrated ownership leads to more careful monitoring and closer scrutiny of bank operations, including lending practices, which helps in minimizing the chances of loan defaults. The negative relationship between leverage and NPLs implies that banks with higher leverage tend to have fewer non-performing loans. This may be because leveraged banks are more focused on maintaining high-quality loans to ensure they meet debt obligations, thereby reducing the risk of defaults.

However, there is a positive relationship between board independence and NPLs, meaning that higher board independence is linked to more non-performing loans. Independent board members, while offering valuable external perspectives, may be less familiar with the bank's daily operations, which can slow decision-making and hinder the timely identification of emerging risks, leading to higher NPLs. Similarly, the positive relationship between foreign capital and NPLs suggests that an increase in foreign capital may encourage riskier lending practices, as foreign investors often seek higher returns, which can lead to more defaults

Regarding the cash reserve ratio (CRR), Table 3 shows a positive relationship between board size and CRR, indicating that larger boards tend to maintain higher cash reserves. This could be due to a more cautious approach to risk management, where larger boards prioritize financial stability and opt for higher reserves as a buffer. Similarly, the positive relationship between the audit committee and CRR suggests that a stronger audit committee is linked to higher cash reserves. A well-functioning audit committee enhances oversight and risk management, encouraging the bank to maintain higher reserves to ensure financial security.

The positive relationship between ownership structure and CRR indicates that banks with more concentrated ownership structures are more likely to have higher cash reserves. This could be because major shareholders have a vested interest in maintaining financial stability, ensuring the bank holds adequate reserves to manage potential risks. The positive relationship between leverage and CRR suggests that banks with higher leverage tend to keep higher cash reserves. This may be due to the increased financial risk associated with higher leverage, prompting banks to maintain larger reserves as a precautionary measure.

Similarly, the positive relationship between board independence and CRR indicates that independent boards are more likely to focus on maintaining higher cash reserves. Independent directors may adopt more conservative financial strategies, prioritizing liquidity and safety. In contrast, the negative relationship between foreign capital and CRR suggests that banks with more foreign capital tend to have lower cash reserves. Foreign investors often seek higher returns and may push banks to use funds for expansion or other financial activities instead of holding large reserves.

In summary, the relationships between governance factors and NPLs reflect how various board structures and ownership dynamics can influence a bank's ability to manage risks and defaults. On the other hand, the relationships with CRR show how these same factors contribute to a bank's liquidity and financial stability, with stronger governance structures generally promoting higher reserves for safety.

Regression analysis

Table 4 presents the results of panel data of 20 commercial banks with 180 observations for the period of 2015/16-2023/24 by using the linear regression model and the model is $NPL_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 AC_{it} + \beta_3 OS_{it} + \beta_4 LEV_{it} + \beta_5 BI_{it} + \beta_6 FC_{it} + e_{it}$ where, the dependent variable is NPL (Nonperforming loan as measured by the ratio of total equity to total assets, in percentage). The independent variables are BS (Size of board, in numbers), AC (Audit committee measured as return on assets, in numbers.), OS (Ownership structure measured as the number of shares of common stock, in percentage), LEV (Leverage as measured as total debt to total equity, in times), BI (Board independence measured as number of independent directors to total directors on the board, in numbers) and FC (Foreign capital measured as capital of investor from foreign, in percentage).

Table 4: Estimated regression results of board size, audit committee, ownership structure, leverage, board independence and foreign capital with non-performing loan.

Model	Intercept	Regression coefficients of						Adj. R_bar^2	SEE	F-value
		BS	AC	OS	LEV	BI	FC			
1	1.255 (1.090)	0.114 (0.698)						0.004	2.297	0.487
2	4.613		-0.847					0.054	2.230	8.934

	(5.247)**		(2.989)**							
3	2.482 (4.928)**			-0.007 (0.938)				0.001	2.294	0.879
4	2.217 (4.759)**				-0.180 (0.403)			0.006	2.300	0.162
5	1.763 (2.970)**					0.317 (0.505)		0.005	2.299	0.255
6	2.041 (9.366)**						0.000 (0.052)	0.007	2.301	0.003
7	3.133 (2.521)*	0.276 (1.673)	-0.991 (3.365)**					0.066	2.216	5.925
8	3.876 (2.774)*	0.256 (1.550)	-1.018 (3.451)**	-0.009 (1.158)				0.068	2.213	4.407
9	3.903 (2.776)*	0.263 (1.565)	-1.016 (3.431)**	-0.008 (1.074)	-0.112 (0.251)			0.062	2.220	3.298
10	3.717 (2.486)*	0.259 (1.529)	-1.015 (3.414)**	-0.008 (1.050)	-0.114 (0.254)	0.231 (0.378)		0.056	2.228	2.650
11	5.502 (3.287)**	0.283 (1.692)	-1.420 (4.128)**	-0.013 (1.683)	-0.167 (0.378)	0.122 (0.201)	-0.024 (2.245)*	0.084	2.195	3.115

Notes:

Figures in parenthesis are t-values.

The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent level respectively.

Non-performing loan is the dependent variable.

Table 4 reveals that board size has a positive association with non-performing loans (NPLs), meaning that larger boards tend to have more non-performing loans. This could be due to challenges in decision-making and coordination that arise with larger boards, which may dilute accountability and weaken oversight, leading to riskier lending practices and higher defaults. This finding aligns with Pearce and Zahra (1992), who also highlighted the inefficiencies associated with larger boards.In contrast, the negative relationship between the audit committee and NPLs indicates that a stronger audit committee helps reduce non-performing loans. A well-functioning audit committee plays a key role in monitoring and overseeing the bank's operations, ensuring better risk management, and minimizing the risk of poor lending decisions. This finding is consistent with Tsorhe et al. (2011), who found that effective audit committees lead to lower NPLs.

Similarly, the negative relationship between ownership structure and NPLs suggests that banks with more concentrated ownership tend to have fewer non-performing loans. When ownership is concentrated, major shareholders are more likely to actively monitor the bank's lending practices, leading to more prudent decision-making and fewer defaults. This aligns with Kalluru (2009), who found that concentrated ownership reduces the likelihood of NPLs.The negative relationship between leverage and NPLs implies that banks with higher

leverage tend to have fewer non-performing loans. This could be because leveraged banks are more cautious with their lending, as they face greater financial obligations. This focus on risk management helps reduce the chances of loan defaults. Ahmad et al. (2015) similarly found that higher leverage encourages better risk control to avoid NPLs.

On the other hand, the positive relationship between board independence and NPLs indicates that more independent boards are associated with higher non-performing loans. Independent directors may lack familiarity with the bank's day-to-day operations, which could result in slower decision-making and a delayed response to emerging risks, ultimately leading to more defaults. This is consistent with the findings of Ezzamel & Watson (1993), who suggested that independent directors might inadvertently increase risks.Lastly, the positive relationship between foreign capital and NPLs shows that banks with higher levels of foreign capital tend to experience more non-performing loans. Foreign investors often seek higher returns and may encourage riskier lending practices to achieve those returns, leading to an increase in defaults. This contrasts with the findings of Zhong et al. (2007), who argued that foreign capital generally stabilizes banks and reduces NPLs.

The regression results of board size, audit committee, ownership structure, leverage, board independence and foreign capital with non-performing loan of Nepalese commercial banks have been presented in Table 5.

The results are based on panel data of 20 commercial banks with 140 observations for the period of 2014/15-2020/21 by using the linear regression model and the model is $CRR_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 AC_{it} + \beta_3 OS_{it} + \beta_4 LEV_{it} + \beta_5 BI_{it} + \beta_6 FC_{it} + e_{it}$ where, the dependent variable is CRR (Cash reserve ratio as measured by reserve requirement to bank deposits, in percentage). The independent variables are BS (Size of board, in numbers), AC (Audit committee measured as return on assets, in numbers.), OS (Ownership structure measured as the number of shares of common stock, in percentage), LEV (Leverage as measured as total debt to total equity, in times), BI (Board independence measured as number of independent directors to total directors on the board, in numbers) and FC (Foreign capital measured as capital of investor from foreign, in percentage).

Table 5: Estimated regression results of board size, audit committee, ownership structure, leverage, board independence and foreign capital with cash reserve ratio.

Model	Intercept	Regression coefficients of						Adj. R_bar^2	SEE	F-value
		BS	AC	OS	LEV	BI	FC			
1	2.722 (0.610)	1.730 (2.728)*						0.044	8.909	7.444
2	2.995 (0.866)		3.875 (3.475)**					0.074	8.770	12.078
3	14.619 (7.278)**			0.002 (0.060)				0.007	9.146	0.004
4	14.134 (7.632)**				0.631 (0.354)			0.006	9.142	0.126
5	11.494 (4.904)**					3.625 (1.461)		0.008	9.076	2.136
6	15.469 (18.095)**						-0.069 (1.915)*	0.019	9.027	3.668
7	-3.440	1.199	3.250					0.090	8.694	7.865

	(0.705)	(1.855)*	(2.813)*							
8	-5.083 (0.924)	1.242 (1.907)*	3.310 (2.850)*	-0.009 (0.652)				0.086	8.712	5.363
9	-4.991 (0.902)	1.265 (1.910)*	3.318 (2.845)*	0.021 (0.679)	-0.373 (0.212)			0.080	8.743	4.005
10	-7.631 (0.305)	1.200 (1.813)*	3.339 (2.872)*	0.023 (0.753)	-0.397 (0.226)	3.265 (1.365)		0.085	8.715	3.597
11	-7.079 (1.061)	1.207 (1.814)*	3.214 (2.345)*	0.021 (0.665)	-0.413 (0.234)	3.231 (1.341)	-0.007 (0.174)	0.079	8.747	2.981

Notes:

Figures in parenthesis are t-values.

The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent level respectively.

Cash reserve ratio is the dependent variable.

Table 5 shows that the beta coefficients for board size is positive with cash reserve ratio. It indicates that the board size has a positive impact on cash reserve ratio. This could be due to efficiencies in decision-making and coordination challenges that often arise in larger boards, increasing bank's ability to address emerging risks. In the context of Nepal, board members may also be appointed for symbolic or political reasons rather than for their financial expertise, which can further reduce the effectiveness of oversight and increase the likelihood of CRR. This finding is like the findings of Sarkar and Sarkar (2018). Similarly, the beta coefficients for audit committee are positive with cash reserve ratio. It indicates that audit committee has a positive impact on cash reserve ratio. The positive impact of the audit committee on the cash reserve ratio suggests that stronger oversight by the audit committee could enhance the bank's financial stability, leading to a larger reserve. This finding is consistent with the findings of Beasley (1996). Likewise, the beta coefficients ownership structure is positive with cash reserve ratio. It indicates that ownership structure has a positive impact on cash reserve ratio. For instance, banks with more concentrated ownership may have better incentives to manage risk carefully and maintain adequate reserves to protect their investments. Similarly, the nature of the owners (whether they are individuals, institutional investors, or government entities) could influence the strategic approach to financial stability, prompting them to maintain a higher cash reserve ratio. This finding is similar to the findings of Chege (2013). Similarly, the beta coefficients for leverage are positive with cash reserve ratio. It indicates that leverage have positive impact on cash reserve ratio. Higher leverage could increase the bank's risk profile, as borrowing amplifies both potential returns and potential losses. To mitigate this heightened risk, banks may maintain higher cash reserves to ensure they can meet their obligations in case of adverse financial conditions. This is consistent with the precautionary motive for holding cash reserves, where banks are more cautious with higher leverage. This finding is consistent with the findings of Berger and Di Patti (2006). However, the beta coefficients for board independence are positive with cash reserve ratio. It indicates that board independence has a positive impact on cash reserve ratio. This can lead to more effective oversight of financial risks, including ensuring that adequate cash reserves are maintained to weather financial challenges. The independence of the board reduces the potential for conflicts of interest or undue influence, which might otherwise lead to risky financial practices that could deplete reserves. This finding is similar to the findings of Ezzamel & Watson (1993). Similarly, the beta coefficients for foreign capital are negative with cash reserve ratio. The negative relationship between foreign capital and the cash reserve ratio could be explained by the fact that foreign investors might prioritize higher returns and prefer more aggressive financial strategies, including lower reserves. Foreign capital often comes with different expectations, such as more pressure on the bank to maximize profitability or take on more risk in the hope of achieving higher returns. This finding is inconsistent with the findings of Qiao *et al.* (2022).

SUMMARY AND CONCLUSION

Corporate Governance is a system of rules, practices and processes by which a company is directed and controlled (Organization for Economic Co-operation and Development (OEDC), 2004). Since the banking system contributes a significantly specific role in the economy, corporate governance is critical and so the risk management is essential in financial institutions. Likewise, Financial risk is the possibility of losing money on an investment or business venture. Some more common and distinct financial risks include credit risk, liquidity risk, and operational risk. Financial markets face financial risk due to various macroeconomic forces, changes to the market interest rate, and the possibility of default by sectors or large corporations. The primary aim of this study is to investigate the factors influencing corporate governance and its effect on the financial risk of Nepalese commercial banks. The research is based on secondary data from 20 commercial banks, with 180 observations spanning from the fiscal years 2015/16 to 2023/24. The findings reveal that board size, board independence, and foreign capital positively impact the non-performing loans of Nepalese commercial banks. On the other hand, audit committee, ownership structure, and leverage have a negative effect on non-performing loans. Additionally, the study indicates that board size, audit committee, ownership structure, leverage, and board independence all have a positive effect on the cash reserve ratio. The research further concludes that loan loss provisions, bank size, and capital ratio are significant determinants of profitability for Nepalese commercial banks. In contrast, foreign capital negatively affects the cash reserve ratio (CRR) of these banks. Ultimately, the study concludes that the audit committee, followed by board size, is the most influential factor explaining changes in financial risk, particularly in terms of non-performing loans and the cash reserve ratio of Nepalese commercial banks.

Policy Implications

Central Bank Regulations

The Nepal Rastra Bank should introduce mandatory governance disclosures, especially around board and audit activities. This would promote consistency and greater accountability.

State-Owned Bank Reform

To reduce NPLs, political interference in credit decisions must be curbed in government-owned banks. External oversight bodies may help ensure transparency.

Strengthening Audit Committees

Audit committees require more authority, financial literacy, and independence. Regulatory reforms should support their development through training and enforcement.

Improving Board Composition

Boards should be formed based on expertise in risk management and finance rather than political or familial links. Transparent selection processes would support this aim.

Future Researcher

The findings indicate that governance mechanisms play a crucial role in managing NPLs in Nepalese banks. Improving board accountability, ownership transparency, and audit strength is essential for financial stability.

Study Limitations

The study used cross-sectional data, which limits the ability to analyze time dynamics. Governance factors were assessed only through quantitative measures. Soft elements, such as board culture, were not included in the assessment.

Future Research Directions

Dynamic panel models, such as GMM, should be applied to address endogeneity. Qualitative governance indicators, including gender diversity, meeting frequency, and CEO duality, should be incorporated into the analysis. Additionally, case studies or mixed methods can be utilized to explore the contextual nuances in governance practices.

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