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EFFECT OF CORPORATE GOVERNANCE MECHANISM ON THE FINANCIAL PERFORMANCE OF BANKS IN NIGERIA

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Abstract

The lingering cases of fraudulent acts and low level of actual financial performanceof Nigerian banks necessitated this study. Thus, this research study examined the effect of corporate governance mechanisms on the financial performance of banks in Nigeria. This study used secondary data derived from the audited financial statements of the sampled banks in Nigeria from 2006 to 2014. Ordinary Least Square (OLS) regression was used to find out the effect of corporate governance variables on banks' performance. Gretl econometric software was used for the analysis. The study observed that board audit committee and directors' equity interest have a positiveand significant effect on financial performance of banks; while board composition has a negativebut significant effect on banks' financialperformance. The study concluded that the existence of board audit committee enhances banks' financial performance.Thus, this study recommended that Banks should have audit committee in their board to enhance a higher financial performance. The members of the audit committee should be given the opportunity to discharge their duties effectively without undue influence.

Keywords: *Corporate governance, bank financial performance.*

1. Introduction

The banking sector in Nigeria had about 89 active players before the consolidation exercise whose overall performance led to the sagging of customers' confidence. There was lingering distress in the industry, the supervisory structures were inadequate and there were cases of official recklessness amongst the managers and directors, while the industry was notorious for ethical abuses (Akpan, 2007). Poor corporate governance was identified as one of the major factors in virtually all known instances of bank distress in the country. Weak corporate governance was seen manifesting inform of weak internal control systems, excessive risk taking, over-ride of internal control measures, non-adherence to limits of authority, disregard for cannons of prudent lending, absence of risk management processes, insider abuses and fraudulent practices remain a worrisome feature of the banking system (soludo, 2004b). This may hinder the public confidence in the Nigerian banks if proper measures are not put in place by regulatory bodies.

More importantly, Caprio, Laeven and Levine (2008) opined that there should be a revision of bank supervision and corporate governance reforms to ensure that deliberate transparency reductions and risk mispricing are acted upon. According to Sanusi (2010), the banking crisis in Nigeria, has been linked with governance malpractices within the consolidated banks which has therefore become a way of life in large parts of the sector. He further said that corporate governance in many banks failed because boards ignored these practices for reasons including being misled by executive management, participating themselves in obtaining unsecured loans at the expense of the depositors and not having the qualifications to enforce good governance on bank management. The boards of directors were further blamed for the decline in shareholders' wealth and corporate failure.

The unethical casesobserved in the Nigerian banking industry in 2009 (for example Oceanic Bank, Intercontinental Bank, Union Bank, Afri Bank, Fin Bank and Spring Bank) were related to the lack of vigilant oversight functions by the board of directors, the board relinquishing control to corporate managers who pursue their own self-interests and the board being remiss in its accountability to stakeholders (Uadiale, 2010). Moreover, the non-executive directors may be compromised, since; they are being paid by the banks they are expected to oversee.

As a result, various corporate governance reforms have been specifically emphasized on appropriate changes to be made to the board of directors in terms of its composition, size and structure (Abidin, Kamal and Jusoff, 2009).

In an effort to address theproblem,this study examined the effect of internal corporate governance mechanismson banks' performance in Nigeria. However, it is set to achieve the following specific objectives:

1. To examine the effect of board audit committee on financial performance of banks in Nigeria.
2. To determinethe effect of board composition on the financial performance of banks in Nigeria.
3. To find out the effect of directors' equity interest on the financial performance of banks in Nigeria.

The following hypotheses stated in null forms were tested:

Hypothesis 1:

H0: Board audit committee has no significant positive effect on the financial performance of banks in Nigeria.

Hypothesis 2:

H0: Board composition has no significant positive effect on the financial performance of banks in Nigeria.

Hypothesis 3:

H0: Directors' equity interest has no significant positive effect on the financial performance of Nigerian banks.

2. Review of Literature

2.1 The Meaning of Corporate Governance

Arun and Turner (2002b) argued that there exists a narrow approach to corporate governance, which views the subject as the mechanism through which shareholders are assured that managers will act in their interests. However, Shleifer and Vishny (1997), Vives (2000) and Oman (2001) as cited in Uwuigbe (2011) observed that there is a broader approach which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they can earn a return on their investment. There is a consensus, however that the broader view of corporate governance should be adopted in the case of banking institutions because of the peculiar contractual form of banking which demands that corporate governance mechanisms for banks should encapsulate depositors as well as shareholders (Macey and O"Hara (2001).

2.2 Theoretical Framework

This research work is guided by stakeholder theory.The theory states that the organization itself should be thought of as grouping of stakeholders and the purpose of the organization should be to manage their interests, needs and viewpoints. This stakeholder management is thought to be fulfilled by the managers of a firm Freeman (1984).

Sundaram and Inkpen (2004a) as cited in Uwuigbe (2011) suggest that "stakeholder theory attempts to address the question of which groups of stakeholder deserve and require management's attention"

The main groups of stakeholders are: customers, employees, local communities, suppliers and distributors, shareholders, the media, general public, business partners, future generations, past founders, academics, competitors, competitors, regulators and governments.

In other to achieve good corporate governance andhigher performance, managers of banks need to understand, appreciate and conscientiously apply the propositions of stakeholders' theory. For every individual or group that have stake in the banks, effort must be made by the managers to protect their interests for the survival and growthof the banks.

2.3 Empirical Review

Findings of reputable researchers on corporate governance and how it affects performance of banks were critically reviewed in this section of our research work.Their views, location, methodology used, results of findings and their recommendations were discussed.

Ashenafi, Kalifa and Yodit (2013) examined corporate governance and impact on bank performance in Ethiopia. A quantitative method of data analysis was employed which involved descriptive and inferential statistical analysis and multivariate regression analysis. The descriptive statistics were used to analyze the means and standard deviations of regression variables. In addition, before conducting regression analysis, various tests were conducted for Classical Linear Regression Model (CLRM) assumptions. The regression results show that explanatory variables such as capital adequacy ratio (CAR), board size (BDSZ), and existence of audit committee (AUDC) have statistically significant negative effect on bank performance while square of capital adequacy ratio (CAR2) and bank size (BKSZ) have a statistically negative effect on performance measured using ROE. Ownership type (OWTP), loan loss provision (LLP) and loan to deposit ratio (LDR) are found to have no significant effect on bank performance.

Therefore, the study recommended the following: 1. As a means to strengthen the commercial banks in Ethiopia, the government of National bank of Ethiopia should be concerned about the level of both the internal and external corporate governance mechanisms of banks. 2. Shareholders should actively take part in establishing good corporate governance in the banks they own in order to earn better and sustainable profits. 3. The National Bank of Ethiopia should encourage banks to implement good corporate governance practices through enacting rules and regulations. 4. Keeping the number of directors in a bank board to a minimum size is recommended, as long as the minimum size enables the board to perform its supervision activities properly. 5. Commercial banks should increase their branches as well as their size in order to improve profitability due to economies of scale. 6. The government and financial institutions as well as business community should work towards the establishment of a formal capital market institutions especially stock exchange which enhances corporate governance, and competition among businesses in the country. 7. Finally, future research should focus on assessing corporate governance mechanisms and firm performance from the perspective of different stakeholders such as employees, management, shareholders and depositors of commercial banks.

Ayorinde,Toyin and Leye (2012) studied the effect of corporate governance on the performance of the Nigerian banking sector. The judgmental sampling technique was used in selecting the 15 listed banks out of 24 banks that met the consolidation date line of 2005. These banks were considered because they were listed in the Nigerian Stock Exchange market which therefore enables them to have easy accessibility to their annual reports which is the major source of their secondary data. A positive correlation was observed between the level of corporate governance items disclosed by the banks and return on equity which is the proxy for performance. This means that banks who disclose more on corporate governance issues are more likely to do better than those that disclose less. More so, a positive correlation was observed between the directors' equity interest and corporate governance disclosure index. This indicates that individuals who form part of management of banks in which they also have equity ownership have a compelling business interest to run them well. This invariably is expected to improve the performance. But board size has strong negative correlation with return on equity. This implies that how large the size of a board is does not have a positive effect on the level of financial performance of commercial banks in Nigeria but a negative effect.

Uwuigbe (2011), researches on corporate governance and financial performance of banks in Nigeria. This study made use of secondary data in establishing the relationship between corporate governance and financial performance of the 21 banks listed in the Nigerian Stock Exchange. A panel data regression analysis method was adopted in analyzing the relationship that exists between corporate governance and the financial performance of the studied banks. The Pearson correlation was used to measure the degree of association between variables under consolidation. From the analysis: 1. An inverse correlation between board size and ROE was seen. This indicates a significant negative effect of board size on the financial performance of the listed banks. 2. Outside directors do have significant but negative impact upon bank performance as measured in terms of ROE (Regression result showed a negative association between the variables). 3. The more banks' equity owned by the directors, the better the banks' financial performance (a strong significant positive correlation). 4. Banks who disclose more on corporate governance issues are more likely to do better than those that disclose less (a positive correlation).

They recommended that: 1. Effort to improve corporate governance should focus on the value of stock ownership of board members, since it is positively related to both future operating performance and to the profitability of disciplinary management turnover in poorly performed banks. 2. Steps should also be taken for mandatory compliance with the code of corporate governance. Also an effective legal framework should be developed that specifies the rights and obligations of a bank, its directors, shareholders, specific disclosure requirements and provide for effective enforcement by the law.

Ahmad and Mensur (2012) examined corporate governance and financial performance of banks in the post-consolidation era in Nigeria. Data were sought from sixty annual reports of 12 banks for the period of 2006 – 2010. The independent samples t-test was employed to analyze data gathered for the study. Multiple regressions (Analysis of Variance) were used to further analyze hypotheses two and three. Findings revealed that Dispersed equity holding does have an impact on the earnings and dividend of banks. Also, board size does not have an impact on profitability of banks. The existence of a chief compliance does not significantly enhance profitability of healthy banks in Nigeria. The study recommends the practice of restrictive equity holding in banks, be upheld. Secondly, the need to strengthen managerial policies so that financial performance can be improved is important as the stress test conducted by CBN and NDIC revealed only a positive operational performance. Also, the compliance status needs to be identified in banks that are yet to comply with this provision, so that efficiency and effectiveness in management is complimented with other internal controls.

3. Methodology

Descriptive and quantitative research designs were used in this study. The population for this study consists of all the 21commercialbanks in Nigeria. The time frame considered for this study is 2006 to 2014. This 9 year period is long enough for banks to have reviewed and implemented the recommendations by the CBN post consolidation code.

The sample size of 17 banks was determined using Yard mathematical notation. The Simple Random sampling technique was used in selecting the sample size of 17 banks out of the 21 commercial banks in Nigeria.

This study used secondary data derived from the audited financial statements of the sample banks in Nigeria between the nine years period from 2006 to 2014. This study also made use of books and other related materials especially the Central Bank of Nigeria Bulletins and the Nigeria Stock Exchange Fact Book. Some of the annual reports that were not available in the NSE fact book were either collected from the corporate offices of concerned banks or downloaded from the banks' corporate website.

The proxies that were used for corporate governance are: Board Audit Committee, Board Composition andDirectors'Equity Interest. Proxy for the financial performance of the banks is Return on Assets (ROA).

Ordinary Least Square (OLS) was used to measure the effect of the predictors on the dependent variable. The analysis was done with the use of gretl statistical software.

This study used a modified version of the second model of Ashenafi, Kelifa and Yodit (2013). The model of Ashenafi et al (2013) is as stated below:

$ROA = a0 + a1BDSZ + a2AUDC + a3CAR + a4CR + a5LLP + a6LDR + a7BKSZ + a8OWTP + a9CAR^2 + E.$

Where:

ROA is return on assets

BDSZ is board size representing the number of directors sitting in the board

AUDC represents the existence of audit committee in the board, dummy variable taking 1 if there is audit committee in the board and 0 otherwise.

CAR is capital adequacy ratio; year-end capital of the bank divided by year-end total risks weighted assets of the bank.

LLP is loan loss provision allowance for loan loss divided by year-end total loans.

CAR^2 is the square of capital adequacy ratio.

The study used two control variables, namely: ownership type (OWTP) and bank size (BKSZ).
BKSZ is bank size measured as a log of the year-end total assets.
OWTP is ownership type with dummy variable taking 1 if the bank is a state-owned and o otherwise.

Thus, the model for the analysis of the work is given below:
ROA = f (BAC, BOC, DEI) - (1)
ROA = a0 + a1BAC + a2BOC + a3DEI+ e - - - - - - - - - - - - - - - - - -- - - - -(2)
Where:
ROA = Return on Assets
BAC = Board Audit Committee
BOC = Board Composition
DEI = Directors' Equity Interest
a1 – a3 = Coefficients attached to the independent variables
e = Error Term.

4. Result and Discussion

Table 4.1: Regression Result

Model 1: OLS, using observations 1-17
Dependent variable: ROA

	Coefficient	*Std. Error*	*t-ratio*	*p-value*	
Const	-0.159848	0.816085	-0.1959	0.84774	
BAC	1.66975	0.599078	2.7872	0.01540	**
BOC	-1.55253	0.849779	-1.8270	0.09074	*
DEI	3.70646	0.904198	4.0992	0.00126	***

Mean dependent var	0.518218	S.D. dependent var	0.472311
Sum squared resid	0.667172	S.E. of regression	0.226541
R-squared	0.813077	Adjusted R-squared	0.769941
F(3, 13)	18.84915	P-value(F)	0.000051
Log-likelihood	3.400375	Akaike criterion	1.199249
Schwarz criterion	4.532103	Hannan-Quinn	1.530542

***, **, * indicates 1%, 5% and 10% level of significance respectively.
Source: Computed by researcher from data extracted from annual report of banks (2006 - 2014) using gretl.

The regression result in table 4.1 shows that independent variables such as Board Audit Committee (BAC) and Directors' Equity Interest (DEI) have a positive effect on Return on Assets (ROA), statistically significant at 5% and 1% respectively.Whereas, Board Composition (BOC) has a negative effect on ROA at 10% level of significance.

The regression output revealed that 81% (R-square of 0.081) of the variations in the dependent variable are explained by the independent variables. This is further justified by an adjusted R-square of 0.077 (77%). The F value of 18.85 is significant with a P-value of zero to four decimal places indicating that changes in the dependent variable are adequately explained by the independent variables.

4.1 Discussion of Findings

The existence of board audit committee in the board of directors of banks has a positive effect on the financial performance of banks as measured with ROA. This means that banks with audit committee in their board perform better than banks without audit committee. This result contradicts the findings of Ashenafi et al (2013) which revealed a negative effect of board audit committee on banks' performance.

Board composition (defined as the proportion of non-executive directors) has a negative effect on banks' performance. This suggests that banks with larger number of non-executive directors perform poorly compared to banks with smaller number of non-executive directors. This could be as a result of the fact that non-executive directors do not have the necessary experience in banking business.This is consistent with the findings of Uwuigbe (2011) and Ayorinde, Toyin and Leye (2012). They find a negative relationship between board composition and banks' financial performance.

The effect of directors' equity interest on the financial performance of banks in Nigeria is positive. This suggests that banks perform better when the directors have equity ownership. Having a stake in the bank compels the directors to do their best for a better performance of the bank. This is also in-line with the findings of Uwuigbe (2011) and Ayorinde et al (2012).

4.2 Hypotheses Testing

Hypothesis 1:

H0: Board audit committee has no significant positive effect on the financial performance of banks in Nigeria.

H1: Board audit committee has a significant positive effect on the financial performance of banks in Nigeria.

From the result of the analysis, board audit committee has a coefficient of 1.67 with a P-value of 0.02, depicting a significant positive effect of board audit committee on the financial performance of banks as measured with ROA.On the premise of this result, the null hypothesis is rejectedwhile the alternative hypothesis is accepted.

Hypothesis 2:

H0: Board composition has no significant positive effect on the financial performance of banks in Nigeria.

H1: Board composition has a significant positive effect on the financial performance of banks in Nigeria.

The result shows that board composition has a coefficient of -1.55 with a P-value of 0.09.This means that board composition has a significant negative effect on banks' financial performance.Based on the result, we therefore accept the null hypothesis which states that board composition has no significant positive effect on the financial performance of banks in Nigeria and reject the alternative hypothesis.

Hypothesis 3:

H0: Director' equity interest has no significant positive effect on the financial performance of banks in Nigeria.

H1: Directors' equity interest has a significant positive effect on the financial performance of Nigerian banks.

From the result of the analysis, directors' equity interest has a positive coefficient of 3.71 with a P-value of 0.00, signaling a significant positive effect of directors' equity interest on the financial performance of banks. Based on this result, the null hypothesis is rejected whereas the alternative hypothesis is accepted.

5. Conclusion and Recommendations

5.1 Conclusion

The existence of board audit committee enhances banks' financial performance. This means that better corporate governance is achieved with the existence of audit committee in the board of directors of banks.

Board composition has adverse effect on the profitability of banks. Thus, having non-executive directors in a large number, result in poor performance of banks.

The directors' equity interest has a positive effect on the financial performance of banks. Therefore, having a stake in the bank motivates the directors to do their best in ensuring a higher performance of their banks.

5.2 Recommendations

The following recommendations were given:

i. Banks should have audit committee in their board to enhance a higher financial performance. The members of the audit committee should be given the opportunity to discharge their duties effectively without undue influence.

ii. Regulatory authorities should not compel banks to increase the number of non-executive directors in their board as this negatively affects the profitability of banks.

iii. Directors should be mandated to own a reasonable amount of equity in the banks they oversee as this is one of the keysto enhance the performance of these banks.

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