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CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF BANKS IN THE POST-CONSOLIDATION ERA IN NIGERIA

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Abstract

The Nigerian banking system went through another type of reform soon after the completion of banking consolidation exercise in 2005. This came after a stress test which was done to ascertain the level of compliance with corporate governance code and soundness of banks in the country. Twelve banks were found to be in substantial compliance with the code of corporate governance and therefore considered healthy. The study has the objective of studying the impact of compliance with corporate governance code on the performance of the banks considered healthy by the Central Bank. The twelve banks considered healthy are the study sample. Data covering the period 2006-2010 were extracted from their financial statements. The study employed two techniques (t-test and ANOVA) to test for the three hypotheses formulated from the mathematical model outlined for the study. Findings revealed an impact of dispersed equity on the profitability of banks. However for board size, findings are mixed; a large board size relates to profitability but does not significantly impact on financial performance. It is recommended that there is the need to strengthen managerial policies so that both operational and financial performance can be improved.

Key words: Dispersed equity holding, Post consolidation, and financial performance.
JEL Classification: G21, G32, G34

1. Introduction

Extant literature, particularly in the last decade has revealed public outrage over financial misdeeds around the world due to the sudden failure of major corporate institutions in both the developed countries and developing economies like Nigeria. This had brought to the fore, the need for the practice of good corporate

governance; which is a system by which corporations are directed and managed with a view to increasing shareholder value and meeting the expectations of other stakeholders. In Nigeria, corporations are supervised by regulatory organs like the Securities and Exchange Commission (SEC), the Central Bank of Nigeria (CBN) and governed by their board of directors through management. It was discovered by SEC in 2003, that in the Nigerian financial sector, poor corporate governance was one of the major factors in virtually all known instances of financial institutions' distress. It was also found that only about 40% of quoted companies, including banks, had recognized codes of corporate governance in place. Consequently, in 2003, SEC in collaboration with the Corporate Affairs Commission released a code of corporate governance. Banks had been expected to comply with the provisions of the code. In addition to that, banks were further directed to comply with the Code of Corporate Governance for Banks and Other Financial Institutions approved earlier in the same year by the Bankers' Committee. However, in 2006, the consolidation of the banking industry necessitated a review of the existing code for the Nigerian Banks. A new code was therefore, developed to compliment the earlier ones and enhance their effectiveness for the Nigerian banking industry. Compliance with the provisions of the Code was mandatory. One of the provisions of the code is that on equity holdings in banks. The provision envisaged increased holdings by individuals and corporate bodies in banks and such holdings should be more than that of government. This provision is influenced by the recognition 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. Furthermore, the code emphasizes that, the practice of free, non-restrictive equity holding has led to serious abuses by individuals and their family members as well as government in the management of banks. Consequently, the code further states that Government direct and indirect equity holding in any bank shall be limited to 10% and an equity holding of above 10% by any investor is subject to CBN's prior approval. Another provision of the code is that on board size. The code stipulates for a maximum board size of 20 directors. This position differs from the board size of 15 provided for by the earlier code issued by the Securities and Exchange Commission (SEC) in 2003. More so, to ensure the effective compliance to the code among several other things, the code requires banks to appoint a chief compliance officer (CCO). The officer is required among other specific duties, to make monthly returns to the CBN on all whistle blowing reports and corporate governance related breaches. And also to ensure corporate governance compliance status report is included in the audited financial statements.

The reforms carried out by the CBN in the banking sector as well as the code issued by the SEC were to bring about optimized corporate governance practices in the industry. However, in 2008, the CBN and the Nigerian Deposit Insurance Company (NDIC) carried out a stress test in the banking industry. The stress test revealed some unwholesome developments in the banking industry which were as a result of non compliance with the corporate governance code by some banks. Some banks were found to be financially unsound and therefore declared unhealthy. Twelve banks were found to be healthy. It is in this context that the study seeks to address the following questions; to what extent has equity holdings and board size relate to and impact on financial performance (FP) of the 12 banks that were considered healthy by the CBN? Are the relationship and impact attributable to the fact that a compliance officer (CCO) exists to ensure compliance with the code? By seeking to address these questions, the study seeks to contribute in bridging the existing gap in knowledge on the impact of corporate governance on financial performance in financial institutions. There are generally few studies (Thomas and Mohammed, 2011) and no studies in Nigeria, known to us, that had looked at the impact of corporate governance on the performance of banks in the period covered by this study (Sanda, Mikailu and Garba, 2005; Kajola, 2008; and James and Okafor, 2011). The remaining part of this paper is structured into five sections, section one is the introduction including this paragraph. Section two, presents the literature in concepts with prior studies. Immediately after that is the methodology, presenting the models and how the study defined and measured it variables. Afterwards, is the discussion of findings and based on the findings the paper concludes and highlights the study's implication in the last section of the paper.

2. Literature Review and Conceptual Frame work

Corporate governance relates to relationship between firm's various legitimate stakeholders. Corporate governance is about making certain that the company is directed appropriately for reasonable return on investments (Magdi and Nadereh, 2002). It is considered to be a process in which affairs of the firm are directed and controlled so as to protect the interest of all stakeholders (Sullivan, 2009). The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs (Uche, 2004 and Akinsulire, 2006).

Corporate governance is concerned with the processes, systems, practices and procedures that govern institutions. It is also concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claim holders, corporate governance rules can be seen as the outcome of the contracting process between the various principals or constituencies and the CEO (Becht et al, 2005). There are other perspectives on corporate governance, the corporation's perspective and the public policy perspectives. The corporation's perspective is about maximizing value subject to meeting the corporation's financial, legal, contractual, and other obligations. This perspective stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders – employees, customers, suppliers, investors, etc – in order to achieve long term sustained value for the corporation. From a public policy perspective, corporate governance is about nurturing enterprises while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders. These two perspectives provide a framework for corporate governance that reflects the interplay between internal incentives and external forces that govern the behavior and performance of the firm (Iskander, Magdi and Chamlou, 2000).

2.1 Equity Holdings

This subsection presents the meaning of equity holding by using the position of the CBN code of corporate governance and the review of other studies. Equity holding is the same as equity ownership or position. It can also be referred to as share ownership which is defined as the ownership by an investor of a number of shares in a corporation. The provision on equity holding is influenced by the recognition 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 view is upheld in the studies conducted by Gordon and Schmid, (1996) and James and Okafor (2011) in which they found that directors' share holding significantly impacts on firm's performance. A number of studies however, upheld mixed positions regarding equity holdings, specifically for employees of a corporation and ownership that is dispersed (For example Becht et al, 2005; Roberts and Van den Steen; Bolton and Xu, 2001). On dispersed ownership, some studies have posited inconclusively that, there is a link between ownership dispersion, voting control and corporate performance. Study by Monsen et al (1968) argues that free-riding among dispersed shareholders leads to inferior company performance. However, a study by Gugler (2001) finds that ownership

concentration improves governance and performance at least for family owned firms. The study by Anderson and Ribstein (2003) confirms that family firms consistently outperform their peers as measured by accounting yardstick like return on asset and market valuation measures such as Tobin's q. However, Demsetz and Lehn (1985) explain that it all depends on the nature of the firm. Some firms require large shareholder control while some do not.

2.2 Board Size

Board size is the number of individuals serving on the board of a firm. As earlier mentioned, the code emphasizes that, the number of non-executive directors should be more than that of executive directors subject to a maximum board size of 20 directors (CBN, 2006) and 15 directors (SEC, 2003). What this implies is that, large board sizes are emphasized by both codes. Extant literature has revealed mixed positions regarding board size and firm performance. While some studies posit that the smaller the board size the higher the performance, (Jensen 1993; Sanda, Mikailu and Garba, 2005; and James and Okafor, 2011); others show that the higher the number of directors sitting on the board the better the performance (Belkhir, 2006; Adams and Mehran, 2010). Fich and Shivdasani (2006), Adam and Meheran (2010) and Thomas and Muhammed (2011) however, add that firm performance can deteriorate if busier directors serve on the board. But Yermach (1996) and Eisenberg et al (1998) find negative relationship between board size and firm performance; Bhagat and Black (2002) say the negative relationship is not strong. Arguing differently, Mak and Li (2001) posit that, the nature and significance of the relationship between board size and performance is sensitive to the estimation methods used.

3. Methodology

The objective of this study is to determine the relationship and impact of compliance with corporate governance code on financial performance (FP) of the 12 banks that were considered healthy by the CBN. Data were sought from sixty annual financial reports of 12 banks for the period 2006-2010. The choice of this period is influenced by the fact that, it is the period immediately after the consolidation of the banking sector. The study developed a model and specified variables for testing the hypotheses formulated for the study. Four accounting ratios (Earnings per share [EPS], Dividend per share [DPS], Profit before tax margin [PBTM] and Profit after tax margin [PATM]) are used as proxies for the dependent variable, corporate financial performance (FP). The choice of these proxies is based on the assertions that, earnings paid and dividends declared are an indication of a bank's ability to retain earnings for expansion and further

distribution to shareholders, and also they indicate whether or not the expenses of running a business are proportionate to the amount of trade, which implies good corporate governance. For the independent variable corporate governance (CG); Dispersed equity holding [DEH], Board size [BS] and Compliance statue (CCO) were identified. The choice of these proxies is influenced by the fact that there is the encouragement of holdings by individuals and corporate bodies in banks and that such holding should be more than that of government given a board size of 20. SPSS version 17 was used to aid the analysis of data collected.

3.1 Population and Sample of the Study

The population of the study is the 12 banks quoted on the Nigerian stock exchange that were considered healthy by the CBN. These banks are also the sample of this study. This implies $n = N = 12$. Where: n = Sample size and N = Population size. Arising from the above, Access Bank, Fidelity Bank, Guarantee Trust Bank, First Bank, First City Monument Bank, Stanbic IBTC Bank, Skye Bank, Zenith Bank, Sterling Bank, Eco Bank, Diamond Bank, and United Bank for Africa constitute the sample.

3.2 Model and Variable Specification

Three hypotheses were formulated based on the objectives of this study:

H_{O1} Dispersed Equity holding (DEH) does not significantly impact on EPS and DPS of banks in Nigeria

H_{O2} Board size does not significantly relate and impact on profitability of banks in Nigeria

H_{O3} the existence of Chief Compliance Officer does not significantly enhance profitability of banks in Nigeria.

For the first hypothesis, earning per share (EPS) and dividend per share (DPS) are used as proxies for financial performance (FP). And for hypotheses two and three, PBTM and PATM were used as proxies. The following model was developed to test hypotheses two and three: FP f (BS) + (CCO).

The proxies for the independent variable (dispersed equity, board size and compliance officer) were treated as dichotomous variables. Binary number 1 was assigned where directives in the code for dispersed holding, board size of not more than 20 and the existence of compliance officer were complied with, if otherwise, 0 was assigned.

3.3 Techniques of Data analysis

The independent samples t-test was employed to analyze data gathered for the study. The choice of this technique is based on the fact that, all the study is trying

to do, is to compare the means of two groups for a single variable. To achieve the independent samples for the study, the proxies for the dependent variable were grouped into 2. As a result, the EPS and PBTM for the period under review were assigned binary number 1 as the group one. For group two, DPS and PATM, binary number 2 was assigned. Multiple Regressions (Analysis of variance [ANOVA]) was used to further analyse hypothesis two and three.

4. Discussion of Findings

Hypotheses were formulated to achieve the objective of this study. The first hypothesis is formulated to determine the extent to which (DEH) impacts on FP (EPS and DPS) in Nigerian Banks.

Table 4.1 Group Statistics

Corporate Governance and Financial Performance	Mean
EPS	85.3600
DPS	40.8200
PBTM	21.7560
PATM	15.8550

Source: From SPSS output listing 2012

In the table 4.1, the mean for group one (EPS) is 85.3600 and that of group two (DPS) is 40.8200. The result reveals there is a difference between the means of the two groups is significant, the mean of the second group is almost half of the first group. Also, the mean for group one (PBTM) is 21.7560 and that of group two (PATM) is 15.8550. The result reveals the difference between the means of the two groups is not wide and therefore, not significant.

Table 4.2 Independent Samples

Corporate Governance and Financial Performance	**F**	**Significance (2-tailed)**
Dispersed equity	4.35	0.48
Board size	0.10	0.40

Source: From SPSS output listing 2012

In the table 4.2, the levene test is significant, so the t value calculated with the pooled variance estimate (equal variance) is not appropriate. With a 2- tail significant value (i.e. p-value) of 0.048 (i.e. 5% approximately), the difference between the mean is significant. This implies dispersed equity holding, does have an impact on the earnings and dividend of banks. Based on these results, the

hypotheses which states dispersed equity holding (DEH) does not significantly impact on earnings per share (EPS) and dividend per share (DPS) of banks in Nigeria, is rejected. This finding is in line with the findings of Gordon and Schmid, 1996; Holmstrom, (1999); Roberts and Van den Steen (2000); Gugler, (2001); Becht et al, (2005); and James and Okafor, (2011). The second hypothesis was formulated to determine whether board size significantly relates and impacts on profitability of banks considered healthy in Nigeria. In tables 4.2, the F value is at 0.10, this means the levene's test is not significant. This translates into the t value calculated with the pooled variance estimate (equal variance) to be appropriate. With a 2- Tail significant value (i.e. p-value) of 0.40, the difference between the mean is not significant. This implies, board size does not have an impact on profitability of banks. Based on these results the hypothesis; **Ho$_2$** Board size does not significantly relate and impact on profitability of healthy banks in Nigeria, is accepted. This findings is in line with the studies by Jensen 1993); Sanda, Mikailu and Garba, (2005) and James and Okafor, (2011).

Table 4.3 ANOVA

Corporate Governance and Financial Performance	**F**	**Sig**
Board size and Profitability	5.358	0.024
	7.112	0.010
Compliance officer and Profitability	0.244	0.623
	0.450	0.505

Source: From SPSS Output listing 2012

Furthermore table 4.3 above, provides evidence of a significant relationship between board size and profitability. Which findings are in line with the studies by Belkhir, (2006) and Adams and Mehran, (2010). In the table, the F value is 5.358 and 7.112 with a significant level of 0.024 and 0.010 respectively. This implies the presence of a significant relationship between board size and profitability. On the other hand, there is the absence of a significant relationship between financial performance and the presence of compliance officer as the F value of 0.244 and 0.450 with a significant level of 0.623and 0.505 respectively indicates the absence of a significant relationship. Therefore, the hypothesis which states: **Ho$_3$** the existence of a chief compliance officer does not significantly enhance profitability of healthy banks in Nigeria, is accepted.

5. Conclusions

Based on the findings, the study concludes (DEH) has a significant impact on FP (EPS and DPS), Board size of 20 relates to profitability but, does not have a significant impact on financial performance of banks. Furthermore, the impact of dispersed equity holding on the profitability of banks as well as the relationship between board size and profitability is not attributable to the existence of a compliance officer. 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. 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.

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