The Role of Non-Executive Directors in the Profitability of Banks: A Study of Universal Banks in Nigeria

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Abstract

In Nigeria, Banks' multifaceted and pivotal role in the economic system has attracted regulatory attention in an effort to inspire sound corporate governance standards and address the unique features of risks faced by credit institutions. The composition of the board of directors therefore constitutes one of the most essential corporate governance themes and has caught the attention of academics and regulators alike. This paper therefore employed secondary data covering a period of 3 post consolidation years (2006-2008) in studying the effects of the proportion of non executive directors on the profitability of the listed banks in Nigeria. A panel data regression analysis was used in analysing the variables under consideration. The paper observed from the findings that a negative but significant relationship exists between ROE and NED. The paper concludes that the negative association is likely to be because non executive directors are too busy with other commitments and are only involved with the company business on a part-time basis. We therefore recommend that in other to have proper monitoring by independent directors, bank regulatory bodies should require additional disclosure of financial and personal ties between directors and the organizations they work for.

Keywords: Governance, Nigeria, Banks, Profitability

1. Introduction

Over the past two decades, particular attention in both the academic and professional literatures (Jensen, 1993; Hermalin & Weisbach 1991; Bhagat, & Black, 2002) has been directed towards the role of corporate governance in company administration. More so, following corporate scandals in most of the developed world, a number of recommendations into the administration of publicly quoted companies in different countries have focused attention on the importance of corporate governance in protecting the interests of shareholders.

Jensen and Meckling (1976) acknowledged that the principal-agent theory which was also adopted in this study is generally considered as the starting point for any debate on the issue of corporate governance. A number of corporate governance mechanisms have been proposed to ameliorate the principal-agent problem between managers and their shareholders. These governance mechanisms as identified in agency theory include board size, board composition, CEO pay performance sensitivity, managerial ownership and share holder right

However, given the furry of activities that has affected the efforts of banks to comply with the various consolidation policies and the antecedents of some operators in the system, there are concerns on the need to strengthen corporate governance in banks. This will boost public confidence and ensure efficient and effective functioning of the banking system (Soludo, 2006). According to Heidi, and Marleen (2003:4), banking supervision cannot function well if sound corporate governance is not in place. Consequently, banking supervisors have strong interest in ensuring that there is effective corporate governance at every banking organization. As opined by Mayes, Halme and Aarno (2001), changes in bank ownership during the 1990s and early 2000s substantially altered governance of the world's banking organization. These changes in the corporate governance of banks raised very important policy research questions. The fundamental of such questions is how do these changes affect bank performance? Banks' multifaceted and pivotal role in the economic system has therefore attracted, not without valid reasons, much regulatory attention in an effort to inspire sound corporate governance standards and address the unique features and risks faced by credit institutions. The composition of the board of directors therefore constitutes the most essential corporate governance themes and has caught the attention of academics and regulators alike.

To stem the temptation of management to serve their own interests, board directors in a modern corporation are charged to monitor management behaviors with the objective of representing and protecting the interests of shareholders (Jensen and Meckling, 1976; Berle and Means, 1933). This is particularly true for outside directors who are independent and are different from inside managing directors. Since inside directors may not feel compelled to contradict the other executives or the CEO, outside directors are in a better position to monitor managerial activities and performance (Weisbach, 1988). As such, it is expected that board independence is associated with enhanced corporate performance and valuation for shareholders. Such expectations, however, have not been demonstrated empirically in a developing economy like Nigeria.

It is against these backdrops that this study therefore empirically investigates the role of non executive directors in the performance of banks in Nigeria.

1.1 Scope of Study

This study investigates the relationship between corporate governance and financial performance of banks. The choice of this sector is based on the fact that the banking sector's stability has a large positive externality and banks are the key institutions maintaining the payment system of an economy that is essential for the stability of the financial sector. Financial sector stability, in turn has a profound externality on the economy as a whole. To this end, the study basically covers the 24 universal banks operating in Nigeria till date that met the N25 billion capitalization dead-line of 2005. The study covers these banks' activities during the post consolidation period i.e. 2006- 2008. The choice of this period would have allowed for a significant lag period for banks to have reviewed and implemented the recommendations by the CBN post consolidation. However it was not possible to obtain the annual reports of 2009/2010 since they are yet to be published by majority of the banks.

1.2 Research Hypothesis

The hypothesis to be tested is stated below in the null form.

H_0: There is no significant relationship between the proportion of non- executive directors on a board and the financial performance of banks in Nigeria

2. Literature Review

2.1 Corporate Governance Defined

Corporate governance, as a concept, can be viewed from at least two perspectives. Arun and Turner (2002e) opined 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) 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 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). Arun and Turner (2002) joined the consensus by arguing that the special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to restrain the behaviour of bank management. They further argued that, the unique nature of the banking firm, whether in the developed or developing world, requires that a broad view of corporate governance, which encapsulates both shareholders and depositors, be adopted for banks. They posit that, in particular, the nature of the banking firm is such that regulation is necessary to protect depositors as well as the overall financial system.

This study therefore adopts the broader view and defines corporate governance in the context of banking as the manner in which systems, procedures, processes and practices of a bank are managed so as to allow positive relationships and the exercise of power in the management of assets and resources with an aim of advancing shareholders' value and shareholders' satisfaction together with improved accountability, resource use and transparent administration.

2.2 Corporate Governance and Banks

Corporate governance is a crucial issue for the management of banks, which can be viewed from two dimensions. One is the transparency in the corporate function, thus protecting the investors' interest (reference to agency problem), while the other is concerned with having a sound risk management system in place (special reference to banks) (Jensen and Meckling, 1976).

The Basel Committee on Banking Supervision (1999) states that from a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management. This thus affect how banks:

i) set corporate objectives (including generating economic returns to owners);

ii) run the day-to-day operations of the business;

iii) consider the interest of recognized stakeholders;

iv) align corporate activities and behaviours with the expectation that banks will operate in safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors.

The Committee further enumerates basic components of good corporate governance to include:

a) the corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;

b) a well articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;

c) the clear assignment of responsibilities and decision making authorities, incorporating hierarchy of required approvals from individuals to the board of directors;

d) establishment of mechanisms for the interaction and cooperation among the board of directors, senior management and auditors;

e) strong internal control systems, including internal and external audit functions, risk management functions independent of business lines and other checks and balances;

f) special monitoring of risk exposures where conflict of interests are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management or key decisions makers within the firm (e.g. traders);

2.3 Corporate Governance and the Current Crisis in the Nigerian Bank

Although the consolidation process in the Nigerian banking sector created bigger banks, it however failed to overcome the fundamental weaknesses in corporate governance in many of these banks. The huge surge in capital availability occurred during the time when corporate governance standards at banks were extremely weak. In fact, failure in corporate governance at banks was indeed a principal factor contributing to the financial crisis Sanusi (2010). According to him, it was well known in the industry that since consolidation, some banks were engaging in unethical and potentially fraudulent business practices and the scope and depth of these activities were documented in recent CBN examinations.

Governance malpractice within the consolidated banks became a way of life in large parts of the sector, enriching a few at the expense of many depositors and investors. Sanusi further opined that corporate governance in many banks failed because boards ignored these practices for reasons including being misled by executive management, participating themselves in obtaining un-secured loans at the expense of depositors and not having the qualifications to enforce good governance on bank management. In addition, the audit process at all banks appeared not to have taken fully into account the rapid deterioration of the economy and hence of the need for aggressive provisioning against risk assets.

In Nigeria as banks grew in size and complexity, bank boards often did not fulfill their functions and were lulled into a sense of well-being by the apparent year-over year growth in assets and profits. In hindsight, boards and executive management in some major banks were not equipped to run their institutions. Some banks' chairmen/CEOs were seen to often have an overbearing influence on the board, and some boards lacked independence while the non- executive directors often failed to make meaningful contributions to safeguard the growth and development of the bank.

However, the Central Bank of Nigeria published details of the extent of insider abuse in several of the banks and it was revealed that CEOs set up Special Purpose Vehicles to lend money to themselves for stock price manipulation or the purchase of estates all over the world. For instance, one bank borrowed money and purchased private jets which the Apex bank later discovered were registered in the name of the CEO's son. In another bank the management set up 100 fake companies for the purpose of perpetrating fraud.

Sanusi further disclosed that 30% of the share capital of Intercontinental bank was purchased with customer deposits. Afri bank used depositors' funds to purchase 80% of its IPO. It paid N25 per share when the shares were trading at N11 on the NSE and these shares later collapsed to under N3. The CEO of Oceanic bank controlled over 35% of the bank through SPVs borrowing customer deposits. The collapse of the capital market wiped out these customer deposits amounting to hundreds of billions of naira. Therefore, a lot of the capital supposedly raised by these so called "mega banks" was fake capital financed from depositors' funds. Based on this, we can conclude that the consolidation process was a sham and the banks never raised the capital they claimed they did (www.centbank.com).

From the review above, it is pertinent to know that board structure is a major player in the good or bad performance of any organization.

2.4 Prior studies on board composition and performance

The composition of board members has been proposed to help reduce the agency problem (Weisbach, 1988). Empirical studies on the effect of board on performance generally show mixed results. While some studies find better performance for firms with boards of directors dominated by outsiders (Pfeffer and Salancik 1978; Pearce and Zahra 1992; Vafeas, 1999), others find no relationship between these (Weisbach, 1988; Mehran 1995; Daily and Ellstrand, 1996; Klein 1998 and Bhagat and Bolton 2005). Daily and Dalton (1992) provided analyses of 54 empirical studies of board composition and 31 empirical studies of board leadership structure and their relationships to firm financial performance. They find little evidence of a relationship between board composition or leadership and firm financial performance.

Furthermore, Bohren and Bernt (2003) showed that the amount of stock owned by individual outside directors is significantly correlated with various measures of firm performance as well as CEO turnovers in poorly performing companies.

Rosenstein and Wyatt (1997) showed that the market rewards firms for appointing outside directors. However, Fosberg (1989) investigated the relationship between the proportion of outside directors and various performance measures and finds no relationship between the two variables. Hermalin and Weisbach (1999) also observed no association between the proportion of outside directors and Tobin's Q; and Bhagat and Black (2002) find no linkage between the proportion of outside directors and Tobin's Q, return on assets, asset turnover and stock returns.

3. Methodology

In analyzing the relationship between board composition (proportion of non executive directors) and financial performance of banks in Nigeria, the panel data regression model was adopted. This is because the study combined time series and cross sectional data. Also, since there is no significant correlation between the unobserved units of observation, specific random effects and the regressors, the random effect model of panel data regression is more appropriate.

While, the Pearson correlation was also used to measures the degree of association between variables under consideration. Furthermore, the proxy for the independent variable is the proportion on non- executive directors (NED), while the proxy for the financial performance of the banks is the accounting measure of performance; return on equity (ROE).

3.1 Model specification

$$ROE_{it} = f(NED_t) \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

$$ROE_{it} = \beta_o + \beta_1 NED_t \quad + e_t \quad \ldots\ldots\ldots\ldots\ldots\ldots (2)$$

Where:

ROE represents Return on equity for banking firms at time t.

NED is the proportion of non- executive directors on the board

et, also represents the error term which account for other possible factors that could influence ROE that are not captured in the model.

The apriori is such that:

β_1NEDt > 0. The implication of this is that a positive relationship is expected between explanatory variables.

Decision rule: Reject H_0 if p value is < .10

Hypothesis Testing: In this section we measure the degree of association between the proportions of non executive directors i.e. (our governance variable) and return on equity (our measure of profitability). From the A priori stated above, a positive relationship is expected between the corporate governance proxy and profitability variable.

Restatement of Hypothesis:

H_0: There is no significant relationship between the proportion of non- executive directors on a board and the financial performance of banks in Nigeria

3.2 Discussion of Findings

From the descriptive statistics result in table 2 (see appendix), it was observed that on the average for the periods under review, the banks made a return on equity of about 25%. Also the average proportion of non executive or outside directors sitting on a board is about 63%. Our R- squared result implies that the proportion of NED is responsible for only about 26% change in ROE and this is further justified by the adjusted R-squared result. On the other hand, the F- statistic result which is significant at 1% shows that our model is free of bias.

However, from the correlation result in table 3 (see appendix), a negative correlation coefficient (r) of -.505 was observed between the dependent and the independent variables. Furthermore, from the regression result in table 6, the negative correlation observed between NED and ROE was seen to be highly significant at 1% and at 5%. We therefore reject our null hypothesis and accept the alternate hypothesis which states that there is a significant relationship between NED and ROE. This invariably means that the more the number of outside directors who are sitting on a board, the lower the financial performance of the bank in terms of ROE. This is therefore consistent with Yermack (1996) and Bhagat and Black (2002) in their study, where they found a negative correlation between the proportion of outside directors and corporate performance. Furthermore, two other studies conducted in UK, Vegas and Theodorou (1998); Laing and Weir, (1999) did not find a correlation between the proportion of non-executive directors and corporate performance. However, our findings disagree with Pearce and Zahra 1992 and Busta (2007) who found a positive relationship between the variables

4. Conclusion and Recommendations

The banking industry is strategically important to the growth of all sectors of an economy and consequently the desired over-all development of a country necessitates that the sector remains healthy and sound. Thus, one major concern that could undermine the strategic importance of the sector is corporate governance. Although the high proportion of non executive directors is supposed to increase profitability, but however, this study concludes that a negative but significant relationship exists between our governance and profitability variables for Nigerian banks. This is likely to be because non executive directors are too busy with other commitments and are only involved with the company business on a part-time basis. This supports Carter and Lorsch, (2004: 45) where they also pointed out that an average director spends only twenty-two days per year on his duties, which is barely enough to perform the essential functions. Indeed it may be wondered whether the directors who put in less than average effort can be discharging their duties adequately.

In addition, as discussed above, non-executive directors are likely not to have a hands-on approach or are not necessarily well versed in the business, hence do not necessarily make the best decisions. This invariably affects the profitability of the banks.

The study therefore recommends that proponents of board independence should note with caution the negative relationship between board independence and future operating performance. Hence, if the purpose of board independence is to improve performance, then such efforts might be misguided. However, if the purpose of board independence is to discipline management of poorly performing firms or otherwise monitor, then board independence has merit. In other to have proper monitoring by independent directors, bank regulatory bodies should require additional disclosure of financial or personal ties between directors (or the organizations they work for) and the company or its CEO. By so doing, they will be more completely independent. Also, banks should be allowed to experiment with modest departures from the current norm of a “supermajority independent” board with only one or two inside directors.

4.1 Suggestions for further study

The limitations of the study have prompted suggestions for further research as listed below;

1) This research has gone some way to exploring corporate governance and corporate performance of banks in a broader context. Further research could explore the relationship in more specific categories for example, in not-for-profit organizations, in government organizations, and in family companies. Since this study focused on the Nigeria banking sector it would be beneficial to have a clearer understanding of corporate governance roles in other types of organizations. Such research could address the similarities and differences of the roles in different organizations and consider also the legal requirements for different organizations.

2) The period of study for this research is three years i.e. (2006-2008), which is the post consolidation period. This limitation was imposed by the non availability of data pertaining to the reviewed banks. However, further research can consider more time frame based on the availability of the annual reports.

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APPENDIX

Table 1. Summary of studies on board composition and performance

Author	Research objective	Methodology	Key findings
O'Sullivan and Diacon 2003	(1) Examined whether mutual insurers employ stronger board governance than their proprietary counterparts. (2) Examined the impact of board composition on the Performance of proprietary(stock) and mutual companies	Data regression analysis 53 life insures operating in the UK over the period 1984-1991	Mutual insurers had greater non-executive representation on their boards. Lack of consistent evidence on non-executive monitoring and impact on performance
Dulewicz and Herbert 2004	Investigated whether there is any relationship between the proportion of non executive directors and behaviour, and company performance	Data based on original study of 134 responses from a cross section of companies. Follow up data based on 86 listed companies (1997-2000) SPSS analysis CFROTA (cash flow return on total assets) ratio used for performance analysis	Board practices on identified tasks not clearly linked to company performance Limited support that companies with independent boards are more successful than others
Uzun, Szewcyz and Varma 2004	Examined the relationship between fraud and board composition, board size, board chair, committee structure and frequency of board meetings,	Constructed database for a sample of 266 companies (133 that were accused of committing fraud and 133 no-fraud) during the period 1978-2001 Regression analysis	Board composition and structure of oversight committees are significantly related to the incidence of corporate fraud. A higher proportion of independent directors indicated a less likelihood of fraud.
Dalton, Daily, Ellstrand and Johnson 1998	Reviewed research on the relationships between board composition, leadership structure and financial performance	Meta-analysis of 54 empirical studies of board composition, 31 empirical studies of board leadership structure	No meaningful relationship between board composition, leadership structure and financial performance.
Millstein and Macavoy 1998	Directors and performance focus on board behavior	Empirical study of 154 firms based on 1991-1995 data	Substantial and statistically significant correlations between an active board and corporate performance
Muth and Donaldson 1998	Examined board independence and performance based on agency stewardship theory	145 listed companies 1992-1994 Statistical analysis	Empirical results inconclusive that board independence has a positive effect on performance
Lawrence and Stapledon 1999	Examined the relationship between board composition and corporate performance. Examined whether independent directors have a positive influence on executive remuneration	Empirical studies – data sample selected from ASX listed companies in 1995. Regression analysis 700 directors sampled	No statistically significant relationship between the proportion of NED's and adjusted shareholder returns Little evidence that board size affects share price performance No evidence that the proportion of executive directors influences CEO

			remuneration
Rhoades, Rechner and Sundaramurthy (2000)	Examined the insider/outsider ratio of boards and company performance. Examined the potential moderating effects of different operational definitions of monitoring and performance	Meta-analysis of 37 studies across 7644 organizations based on initial search of 59 reports with quantitative data on monitoring and performance 1966-1994	Overall conclusions are that there is a small positive relationship between board composition and financial performance. Board and their director quality needs to be further addressed in considering managerial implications of board composition monitoring
Bhagat and Black (2002)	Examined whether there is any relationship between board composition, board size, board independence and firm performance	934 firms using data form 1985-1995 Regression analysis	Low-profitability firms increase the independence of their boards. Firms with more independent boards do not perform better than other firms.

Bhagat, and Bolton (2005)

Table 2. Descriptive Statistics

	Mean	Std. Deviation	N
ROE	.250135	.2340678	72
NED	.628611	.0902470	72

Table 3. Correlations

		ROE	NED
ROE	Pearson Correlation	1	-.505(**)
	Sig. (2-tailed)		.000
	N	72	72
NED	Pearson Correlation	-.505(**)	1
	Sig. (2-tailed)	.000	
	N	72	72

** Correlation is significant at the 0.01 level (2-tailed).

Table 4. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
	R Square Change	F Change	df1	df2	Sig. F Change	R Square Change	F Change	df1	df2
1	.505(a)	.255	.244	.2034756	.255	23.954	1	70	.000

Table 5. ANOVA(b)

Model	Sum of Squares	Df	Mean Square	F	Sig.	
1 Regression	.992	1	.992	23.954	.000(a)	
Residual	2.898	70	.041			
Total	3.890	71				

a Predictors: (Constant), NED

b Dependent Variable: ROE

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Table 6. Coefficients(a)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Correlations		
		B	Std. Error	Beta	Zero-order	Partial	Part	B	Std. Error
1	(Constant)	1.073	.170		6.318	.000			
	NED	-1.310	.268	-.505	-4.894	.000	-.505	-.505	-.505

a Dependent Variable: ROE

Table 7. List of consolidated banks in Nigeria

1) Sterling Bank Plc	7) Access Bank Nigeria Plc	13) Fidelity Bank Plc	19) Oceanic Ban International Nigeria Plc
2) Union Bank of Nigeria Plc	8) Afribank Nigeria Plc	14) First Bank of Nigeria Plc	20) Platinum Habib Bank Plc
3) United Bank For Africa Plc	9) Citibank Nigeria Limited	15) First City Monument Bank Plc	21) Skye Bank Plc
4) Unity Bank Plc	10) Diamond bank Nig Plc	16) First Inland Bank Plc	22) Spring Bank Plc
5) Wema Bank Plc	11) Ecobank Nigeria Plc	17) Guaranty Trust Bank Plc	23) Stanbic IBTC Bank
6) Zenith Bank Plc	12) Equitorial Trust bank	18) Intercontinental Bank Plc	24) Standard Chartered Bank Nigeria Plc

Source: *Source: www.cenbank.financialinstitution.com*