



IMPACT OF CORPORATE GOVERNANCE ON THE PROFITABILITY OF THE NIGERIAN BANKING SECTOR

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Abstract

Corporate governance has, in recent times, raised a great deal of concern due, largely, to massive corporate failures in the domestic and global arena. Governments have in response to rising cases of financial distress taken both pro-active and reactive measures to achieve stability in the sector. However, notwithstanding government interventionist roles, stability of banking operations remains suspect. This study seeks to empirically determine the effect of corporate governance on the profitability of banking sector in Nigeria. Return on equity (ROE) and return on assets (ROA) were adopted as proxies for banking sector profitability while capital adequacy ratio (CAR), liquidity ratio (LQR) and ratio of non-performing loans to total loans (NPL) were adopted as proxies for corporate governance. Inflation rate was introduced as a control variable. Empirical evidence from the study shows significant impact of corporate governance on the profit performance of the Nigerian banking sector. We recommend that the regulatory authorities (CBN, NDIC and SEC) should diligently exercise their oversight functions to ensure strict compliance, by the banking sector, to extant regulations on corporate governance so as to consolidate, or possibly, improve on the gains of the initiative.

Keyword: Corporate governance, profitability, Nigeria, Banking sector.

Introduction

As a concept, corporate governance connotes the processes involved in the discharge of the mandate of governance in corporate entities (Okafor, 2011). It refers to the process through which an organization is governed and controlled. Corporate governance codes define the relationship between company management, their boards and their shareholders as well as require that management and directors carry out their duties within a framework of accountability and transparency (Adeola, 2003).

Corporate governance has become a topical issue because of its immense contributions to the growth of modern economies where the private sector plays a key role in the growth process. Absence of good corporate governance is often blamed for the woeful performance of business entities. Developed private sector-driven economies with history of established corporate governance structures consistently record high and predictable growth rates. Thus low economic growth rates that characterize developing nations are often attributed to low level of corporate governance practices in these economies.

There is substantial evidence of a positive link between firm performance and corporate governance. See for example, Ahmed and Hamdan (2015), Yusuf et al (2015), OECD (2009), Gompers et al (2003), Claessen et al (2002). Shleifer & Vishny (1997), Haris and Raviv (1988), Fama and Jensen (1983), Jensen and Merklung

(1976), Williams (2000), Drobetz et al (2003), Hussain et al (2000), Gemmil & Thomas (2004), etc. However, notwithstanding the avalanche of empirical support for positive effect of corporate governance on firm performance, studies like Hutchinson et al (2002) and Bathala & Rao (1995) find evidence of negative relationship between them while others like Park & Shin (2003) and Singh & Davidson (2003) did not establish any relationship.

In spite of conflicting evidence for corporate governance as a major driver of corporate performance, it is widely acknowledged that lax or inadequate corporate governance practices promote corporate failures. The OECD (2009), for instance, attributes the 2007 global financial crisis to failures and weaknesses of corporate governance structures. Similarly, the 2009 banking crisis that led to the 2010 banking reforms in Nigeria was attributed to weak corporate governance structures in the affected banks (Sanusi, 2009).

The increasing necessity for entrenchment of good corporate governance, in banks and other financial institutions, is underscored by the wave of financial scandals that led to the collapse of the world's giant financial institutions early in this millennium. These corporate failures have been largely attributed to corporate governance failures in these institutions (see for example, Zandi, 2009; Lahart, 2009; Faber, 2009). It is also argued that the transition of global economies from public to private ownership of business equally makes the emphasis on corporate governance more compelling. Adeola (2003) explains that as an economy transits from state ownership of business concerns to a market-based one, the only assurance that the populace will realize the gains of the liberalization exercise is institution of sound corporate governance practice. This may explain why prominent instances of governance-related corporate failures that shook the corporate world at the turn of the century are traced to the US, a known example of a market-oriented economy and they include Enron (2001), Worldcom (2002), Arthur Anderson (2002), etc. A 2003 survey by SEC cited by the CBN (2006) shows that poor corporate governance was identified in most known cases of distress in financial institutions in Nigeria.

Market economies are often characterized by liberalization of banking operations and promotion of competition thereby making banking operations more market-driven. The liberalized banking environment possesses some major challenges particularly in the areas of manpower and regulatory capacity. For instance, a direct consequence of liberalizing the conditionalities for entry into banking business is a sharp increase in the number of licensed banks. To fill the gap created by rapid increase in the number banks in the system, unqualified and incompetent applicants are often recruited while the supervisory and regulatory functions of the Central Bank are longer effectively discharged leading to inefficiencies in corporate governance.

Efficient corporate governance system in the banking sector promotes the integrity of bank management which defines the quality of banking services delivery and influences the overall performance of the sector. Three major codes of corporate governance have been issued to regulate governance-related issues in Nigerian banking by the SEC (2003) and CBN (2006 and 2010). These codes aim at enhancing the integrity of bank management and its capacity to spur growth of the economy through quality-oriented banking services delivery.

To underscore the need for corporate governance as a veritable tool for improved banking sector performance in Nigeria, this study seeks to examine the extent to which the performance of the sector is affected by major indicators of corporate governance. Return on equity (ROE) and return on assets (ROA) were adopted as proxies for profitability while capital adequacy ratio (CAR), liquidity ratio (LQR) and ratio of non-performing loans to total loans (NPL) were adopted as proxies for corporate governance. Inflation was introduced as control

variable. Data on these variables covering the period 2003-2015 were analyzed using the technique of the ordinary least squares.

Conceptual issues in Corporate Governance

Anya (2003) opines that although corporate governance has attracted a great deal of public interest in recent times due, largely, to its importance for the economic health of corporations and society, the concept is rather poorly defined globally since it covers a large number of distinct economic phenomena. Different individuals have explained corporate governance according to their own perception or interest. Notable among them include:

Wolfensohn (1997) cited by Anya (2003) who asserts that corporate governance is about promoting corporate fairness, transparency and accountability. Dyck (2001) conceptualizes it as the ability of the outsiders (shareholders, non-executive directors and other stakeholders) to curtail the grabbing hands of the insiders (directors and managers). Shleifer and Vishny (1997) see corporate governance as a concept by which the suppliers of finance to corporations assure themselves of getting a return on their investments.

Larkan and Tayan (2011) view corporate governance as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interest managers from engaging in activities detrimental to the welfare of shareholders and other stakeholders. At a minimum, the monitoring system consists of a board of directors to oversee management and an external auditor to express an opinion on the reliability of financial statements. In most cases, however, governance systems are influenced by a much broader group of constituents, including owners of the firm, creditors, labour unions, customers, suppliers, investment analysts, the media, and regulators.

OECD (2004) conceives corporate governance to mean a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance outlines the structure through which the objectives of the company are set, the means of attaining those objectives as well as strategies for monitoring performance.

Cadbury (1992) defines corporate governance as the system by which companies are directed and controlled. He explains that the shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the directors include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.

Okafor (2011) posits that corporate governance connotes the processes involved in the discharge of the mandate of governance in corporate entities. These processes enable the realization of the underlying objective of corporate governance which is to maximize shareholders' value without compromising the legitimate expectations of other stakeholders.

Coulson-Thomas (1993) quoted by Adeola (2003) conceptualizes corporate governance thus: Determining what needs to be done; Creating the capability to do what needs to be done; Deciding how to do what needs to be done; Ensuring that what needs to be done is actually done; Ensuring that what is done and how it is done satisfies legal and other requirements; Reporting to shareholders what has been done.

Review of Related Literature

Corporate governance is key to enhanced operational efficiency in banks as it promotes two growth-propelling factors namely, transparency and accountability in an atmosphere of clearly established reporting relationships. Efficiently run banks promote stability of the banking system and thereby support the growth of the economy. Effective corporate governance system ensures that different stakeholders are fairly treated.

In a liberalized or market economy, corporate governance promotes the flow of capital (foreign and domestic) for enhanced economic growth and development due, largely, to its capacity to engender increased investor confidence and goodwill as well as promotion of transparency, accountability, fairness and responsibility. Frost et al (2002) and Donaldson (2003) note that improvements in corporate governance practices promote market liquidity, investor confidence and capital formation due to improved financial disclosures.

For the economy as a whole, effective corporate governance systems present a very effective solution to issues of financial crime thereby promoting the achievement of an investor-friendly environment, a necessary requirement for the inflow of foreign capital. Also, since efficiency of corporate governance structures are directly linked to corporate profit performance, corporate governance has immense potential to drive capital formation through tax revenue.

Evidence in the literature shows that a good system of corporate governance in banks enhances the efficiency of fund allocation, promotes savings thereby reducing not only the cost of funds but also enhancing their access by the ultimate users. Gompers et al (2003) aver that good corporate governance practices increase firm value and boosts profitability.

Empirical evidence of positive correlation between corporate governance and firm performance exists in Ahmed and Hamdan (2015), Yusuf et al (2015), Klapper & Love (2003), Black et al (2003), Drobetz (2004), etc. Also, Drobetz et al (2003) document evidence that good corporate governance practices lead to higher firm valuation. With regard to Board characteristics, Simpson & Gleason (1999) find no significant correlation between corporate governance and bank performance. Kyereboah-Coleman & Biekpe (2006) find that for listed firms on the Nairobi Stock Exchange, those with large boards employ more of debt financing; board independence correlates negatively with short-term debts; and CEO duality correlates negatively with debt financing. Adeusi et al (2013) find positive correlation between board size and bank performance but a significant negative correlation between board composition and bank performance in Nigeria.

Evidence from literature shows that empirical studies on profitability-corporate governance nexus have largely been based on the use of board characteristics rather than firm or industry financials (like capital adequacy ratio, liquidity ratio, non-performing loans, etc.). This study seeks to examine the impact of corporate governance (proxied by capital adequacy ratio, liquidity ratio and ratio of non-performing loans to total loans) on banking sector profitability (proxied by return on equity, return on assets).

Theoretical Framework

According to the cloakroom theory of banking (Cannan, 1921), bank capital is a major determinant of bank performance because of its impact on the credit delivery capacity of a bank. However, Shah (1996) cited by Okafor (2011) argues that beyond bank capital, improvement in risk management is central to bank performance. This implies that a high level of bank capital alone may not automatically translate to improved

performance. Developments in the Nigerian banking sector following the successful implementation of the 2004/2005 bank consolidation exercise clearly supports Shah's argument because there were clear indications that difficulties experienced by some banks after recapitalization derived from lapses in basic corporate governance principles.

The theoretical construct that improvements in corporate governance structures in business organizations are associated with operational efficiency therefore provides the theoretical foundation for this study. The implication is that effective corporate governance systems in the banking sector of the economy is a pre-requisite for enhanced operational performance and thereby value addition. This also supports the agency theory of business espoused by Jensen & Meckling (1976) to explain the relationship between managers (agents) and their principals (investors/business owners). According to the theory, separation of ownership from management of business organizations is saddled with an inherent problem whereby managers tend to promote own interests rather than those of their employers and in the process running down company. Agency problem can take the form of empire building whereby managers seek to entrench themselves in office (La Porta et al, 2000), managerial expropriation which may include fraudulent cash withdrawals, asset stripping, recruitment of unqualified family members, cronies or associates to key managerial positions (Shleifer & Vishny, 1989). According to Shleifer & Vishny (1997), corporate governance seeks to resolve problems of conflict of interest, design ways to avert corporate misconduct and align the interests of stakeholders.

Regulation of Corporate Governance in Nigeria

Basically, three specific guidelines regulate corporate governance practice in the Nigerian banking sector. They are:

The SEC Code of Corporate Governance (2003): Following the report of the Atedo Peterside Committee on Corporate Governance, the SEC issued a code of corporate governance for companies listed on the Stock Exchange, including 7 banks then listed.

The CBN Code of Corporate Governance for Banks (2006): Inability of the 2003 code to decisively contain lapses in corporate governance in banks prompted the issuance of a comprehensive code to regulate governance practices in banks with emphases on ownership structure, organizational structure, board membership, performance appraisal for board, management quality and reporting relationship.

The CBN Prudential Guidelines (2010): Some sections of the guidelines contain regulations aimed at strengthening corporate governance in banks. These provisions cover areas like tenure limitations, executive compensation, limitations on eligibility of former top executives of NDIC and CBN to serve in banks as well as limitations on tenure of external auditors and eligibility of former external auditors to be re-appointed.

Methodology

Secondary data on the selected variables or proxies were collected and analyzed to determine the extent to which corporate governance affects banking sector performance. Two measures of corporate performance, namely return on equity (ROE) and return on assets (ROA), were adopted as proxies for banking sector profitability. ROE measures the amount of profit generated by a firm per naira of shareholder's equity while ROA measures the ability of a firm to generate positive net income from its investments in assets.

The study adopted firm liquidity as proxy for corporate governance. A major objective of corporate governance is to achieve a balance between maintenance of adequate level of liquidity to service customer withdrawal needs and the imperative of avoiding the danger of jeopardizing earning capacity due to excess liquidity. Okafor (2011) identified capital adequacy ratio (CAR) and liquidity ratio (LQR) as measures of long-term and short-term liquidity respectively. Another important component of liquidity management introduced in the study is asset quality, proxied by ratio of non-performing loans to total loans and advances (NPL). Higher ratios of NPL erode liquidity and impair capacity to meet maturing obligations.

The selected proxies for corporate governance are established in literature. For instance, Supriyatna (2006) identified six measures of corporate governance as capital adequacy ratio, cash reserve ratio, secondary reserve securities, loan-to-deposit ratio, loan loss provisioning to total loans ratio and fixed assets and inventories to capital ratio. Konishi and Yasuda (2004) posit that maintenance capital adequacy reduces the incentive for excessive risk-taking by commercial banks and thereby protects stakeholders' interests.

Model Specification and Method of Analysis

The models adopted for this study assume a linear relationship between corporate governance and banking sector profitability. The models were designed to determine the effect of corporate governance on two key profitability ratios. They are specified as follows:

$$\text{Model 1: } ROE_t = \beta_0 + \beta_1 CAR_t + \beta_2 LQR_t + \beta_3 NPL_t + \beta_4 INF_t + \varepsilon_t$$

$$\text{Model 2: } ROA_t = \beta_0 + \beta_1 CAR_t + \beta_2 LQR_t + \beta_3 NPL_t + \beta_4 INF_t + \varepsilon_t$$

Where:

ROE = Return on equity.

ROA = Return on assets.

CAR = Capital adequacy ratio.

LQR = Liquidity ratio.

NPL = Non-performing loans.

INF = Inflation rate.

β_0 = Constant.

β_1 - β_4 = Coefficients to estimated.

ε = Error term.

Data on the selected variables over the period 2003-2015 subjected to econometric tests. The Augmented Dickey Fuller (ADF) method was used to determine the stationary trend of the data. Ordinary least squares (OLS) analytical technique was used to determine the effect of the selected proxies for corporate governance on banking sector profitability. Statistical significance of impact was determined at 10 per cent level of significance.

Empirical Result and Discussions

Unit Root Test:

LROE (Log of ROE)

Null Hypothesis: D(LROE) has a unit root

Exogenous: Constant

Lag Length: 1 (Automatic - based on SIC, maxlag=1)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-6.735485	0.0085
Test critical values: 1% level	-6.423637	
5% level	-3.984991	
10% level	-3.120686	

*MacKinnon (1996) one-sided p-values.

LROA (Log of ROA)

Null Hypothesis: D(LROA) has a unit root

Exogenous: Constant

Lag Length: 1 (Automatic - based on SIC, maxlag=1)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-3.369250	0.0808
Test critical values: 1% level	-3.423637	
5% level	-2.984991	
10% level	-2.120686	

*MacKinnon (1996) one-sided p-values.

LCAR = Log of CAR

Null Hypothesis: D(LCAR) has a unit root

Exogenous: Constant

Lag Length: 0 (Automatic - based on SIC, maxlag=2)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-4.418387	0.0072
Test critical values: 1% level	-4.200056	
5% level	-3.175352	
10% level	-2.728985	

*MacKinnon (1996) one-sided p-values.

LLQR = Log of LQR

Null Hypothesis: D(LLQR) has a unit root

Exogenous: Constant

Lag Length: 1 (Automatic - based on SIC, maxlag=2)

	t-Statistic	Prob.*
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Augmented Dickey-Fuller test statistic	-3.857312	0.0191
Test critical values: 1% level	-4.297073	
5% level	-3.212696	
10% level	-2.747676	

*MacKinnon (1996) one-sided p-values.

LNPL = Log of NPL

Null Hypothesis: D(LNPL) has a unit root

Exogenous: Constant

Lag Length: 0 (Automatic - based on SIC, maxlag=2)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-3.351503	0.0379
Test critical values: 1% level	-4.200056	
5% level	-3.175352	
10% level	-2.728985	

*MacKinnon (1996) one-sided p-values.

LINF = Log of INF

Null Hypothesis: D(LINF) has a unit root

Exogenous: Constant

Lag Length: 1 (Automatic - based on SIC, maxlag=2)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-4.604572	0.1234
Test critical values: 1% level	-4.297073	
5% level	-3.212696	
10% level	-2.747676	

*MacKinnon (1996) one-sided p-values.

The result for all the variables shows evidence of stationarity at 5 per cent level of significance, hence a rejection of the null hypothesis. This suggests a high degree of reliability of estimates derived from the data.

Regression Result

Model 1:

Dependent Variable: LROE

Method: Least Squares

Date: 10/07/16 Time: 21:41

Sample: 2003 2015

Included observations: 11

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.931482	10.55668	0.372416	0.7224
LCAR	0.916492	0.467602	-1.959982	0.0977
LLQR	0.483849	2.384851	0.202884	0.0125

LNPL	0.147340	0.394541	0.373446	0.7217
LINF	-0.144644	0.857828	-0.168617	0.8716
R-squared	0.614213	Mean dependent var	3.191396	
Adjusted R-squared	0.603689	S.D. dependent var	0.816476	
S.E. of regression	0.806747	Akaike info criterion	2.711343	
Sum squared resid	3.905048	Schwarz criterion	2.892204	
Log likelihood	-9.912385	Hannan-Quinn criter.	2.597335	
F-statistic	15.56066	Durbin-Watson stat	1.608526	
Prob(F-statistic)	1.450794			

The result for model 2 shows significant negative impact of capital adequacy ratio (CAR) and liquidity ratio (LQR), at 10 per cent and 5 per cent significant levels respectively, on return on assets (ROA). These results do not conform to *a priori* expectations and are indications of lax corporate governance. They indicate maintenance of sub-optimal (inadequate or excess) levels of liquidity which impairs profit performance. The result also shows significant positive effect of non-performing loans (NPL) on ROA. This result conforms to *a priori* expectation and implies that the level of NPL supports enhanced profitability. Inflation was shown to have a non-significant effect on ROA.

The R-squared value (49.65 per cent) and Adjusted R-squared (47.58 per cent) show that corporate governance proxied by CAR, LQR and NPL as well as INF explain the profit performance of the banking sector to a significant extent. The Durbin-Watson statistic (1.64) shows no auto-correlation.

Summary of Findings, Conclusion and Recommendation

Evidence emanating from the study shows some level of concurrence in the response of different measures of profitability to selected proxies for corporate governance. For instance, the result shows significant negative impact of capital adequacy ratio (CAR) on both measures of profitability (ROE and ROA). There is also evidence of improvement in asset quality as suggested by the positive effect of corporate governance (proxied by NPL) on banking sector profitability. However, while the impact of NPL on ROE is not significant, it was shown to impact ROA significantly. The study also shows significant positive effect of liquidity ratio on return on equity but for return on assets there is evidence of significant negative impact. Finally, inflation was observed to have a non-significant impact on banking sector profitability.

Following from the above results, the study concludes that, over the period of this review, there is evidence that corporate governance has significantly affected the performance of the Nigerian banking sector.

We recommend that the regulatory authorities (CBN, NDIC, SEC) should diligently exercise their oversight functions to ensure strict compliance with extant regulations on corporate governance so as to consolidate, or possibly, improve on the gains of the initiative.

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