

3-1-2009

Corporate governance of banks in Nigeria: determinants of Board of Directors' effectiveness.

Ukpai Kama

Chuku Chuku

Follow this and additional works at: <https://dc.cbn.gov.ng/efr>

Recommended Citation

Kama, U., & Chuku, C. (2009). Corporate governance of banks in Nigeria: determinants of Board of Directors' effectiveness. *Economic and Financial Review*, 47(1), 17-43.

This Article is brought to you for free and open access by CBN Institutional Repository. It has been accepted for inclusion in *Economic and Financial Review* by an authorized editor of CBN Institutional Repository. For more information, please contact jelongshak@cbn.gov.ng.

Corporate Governance of Banks in Nigeria: Determinants of Board of Directors' Effectiveness

*Ukpai Kama and Chuku Chuku**

In the corporate governance of banks, board of directors play a significant role by monitoring and advising management in the formulation and implementation of strategies. Our hypothesis is that certain characteristics of banks' board (size, composition and proactiveness) determine the effectiveness of the boards in carrying out its monitoring and advisory roles. After controlling for heterogeneity and endogeneity using the two-step system estimator, we find that admitting new members into the board improves bank performance up to a certain point, 'efficient limit', where continuous increase of the board size begins to destroy value. We observed an inverse relationship between board meetings and bank performance which suggest to us that bank boards that meet more often are only reacting to bank's poor performance. This challenges the widespread belief that frequent board meetings play a role that is more proactive than reactive. We agree that bank boards strategically alleviate the problems of governance in banks and reduce the weakness of other corporate governance mechanisms, especially regulatory and external governance mechanisms. Hence, empowering boards through incentive packages and enlarged responsibilities with authority to monitor, sanction, reprimand and advise management will be the way forward for the Nigerian banking sector.

Keywords: Corporate governance, Board of directors, Banks in Nigeria, System estimator

JEL Classification: G32, G21, G28, K22

I. Introduction

The obvious lesson to be learnt from the collapse of high profile banks like Lehman Brothers, Barings Bank, Merrill Lynch, Washington Mutual, All States Trust Bank etc., is that no bank is too big (capital base or otherwise) to fail. In the past decade, series of crises both locally and globally have heightened interest in corporate governance practices. These included the collapse of a number of high profile global firms such as Enron Corporation,

* Mr. U. Kama is a staff of Research Department, Central Bank of Nigeria, while Mr. C. Chuku is a NYSC member with the Procurement and Support Services Department, Central Bank of Nigeria, Abuja. The author thanks colleagues in the Department and anonymous reviewers for helpful comments. The views expressed in this paper are those of the authors and do not represent the views of the institution to which they are affiliated or its policy.

WorldCom and Arthur Andersen. Here in Nigeria, weak corporate governance was highly implicated in the travails of Unilever, Spring Bank, Cadbury and many others. A closer examination of the circumstances that ran through these monumental corporate failures reveals that their weak corporate governance mechanism was the culprit (visit www.vogon-international.com for details). Effective corporate governance practice would have ensured proper asset and liability management, prevented insider abuse and fraud by management and ensured the realization of the ultimate objective of a firm, which is to maximize the shareholders value. The implication for banks in emerging markets and, Nigeria, in particular, is that none of the twenty-four (24) recapitalized banks is immuned to failure, especially if they have poor corporate governance culture. Good corporate governance in banks focuses on building strong and effective boards, protecting shareholders and customers' rights, improving the bank's control environment, increasing financial and non-financial transparency and disclosure and ultimately contributing to the development of a sound financial system which guarantees sustainable economic growth.

Thus, to avoid systemic risk, moral hazard, adverse selection and financial panic in the system, the continuous compliance of banks with the principles laid out in the 'Code of Corporate Governance for Banks in Nigeria Post Consolidation' issued by the Central Bank of Nigeria (CBN) will have to be sustained.

The purpose of this paper is to show the role that banks board of directors play in the internal corporate governance of banks, and to investigate the determinants of board of directors' effectiveness. We posit that certain characteristics of bank board (size, composition and proactiveness) determine the effectiveness of the board in carrying out its corporate governance roles, including monitoring, supervising and advising management on mission and strategies.

The paper proceeds as follows: Section 2, presents the literature review and the theoretical and empirical underpinnings of corporate governance research. Section 3 presents an overview of corporate governance in the Nigerian banking sub-sector, while section 4 describes the methodology adopted. Section 5, contains the results of our estimation and finally, section 6 presents the policy options, directions for future research as well as the concluding remarks.

II. Review of Literature

The fundamental insight from which corporate governance research originated is the realization of the potential problems associated with the separation of ownership from control that is inherent in the contemporary corporate form of a firm. These problems have come to be known as 'agency problems'. This insight dates as far back as 1776 when Adam Smith writing about professional managers in his *Wealth of Nations* stated that:

'The Directors of Joint Stock Companies (Banks)... being the managers rather of other people's money (and not their own)... cannot be well expected that they should watch over it with the same anxious vigilance (as owners)... Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company" (Smith, 1776: 700).

Following the realization of the potential for negligence and profusion by managers, several authors have come to define corporate governance from different viewpoints. For example, Sanda et al. (2005) defined corporate governance as ways in which all parties (stakeholders) interested in the well-being of the firm attempt to ensure that managers and other insiders take measures that safeguard the interest of the stakeholders. Zingales (1998), views corporate governance systems as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm. In their work, Shleifer and Vishny (1997) defined corporate governance as the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Taking a universal perspective on the issue, Gillian and Starks (1998) defined corporate governance as the system of laws, rules and factors that control operations at a company. Here, we present a dynamic definition of corporate governance as the moderating instrument through which an organization ensures the optimum allocation of commercial pay-offs among the stakeholders.

Some institutions have defined corporate governance in similar ways. For example, the Code of Corporate Governance issued by the Central Bank of Nigeria (CBN) defines the subject as "a system by which corporations are governed and controlled with a view to increasing shareholder value and meeting the expectations of the other stakeholders." Also, corporate governance is the

system by which business corporations are directed and controlled. 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. By doing so, it also provides the structure through which the company's objectives are set and the means of attaining those objectives and monitoring performance (OECD, 1999).

Generally, corporate governance is regarded as the set of structures, processes, principles and policies that guide the way an institution is directed, administered and controlled. It includes the relationships amongst the many stakeholders involved in pursuing the goals for which the institution was established. The principal stakeholders are the shareholders, board of directors, and management. Others include employees, suppliers, customers, regulators, government and the community at large.

Though the basic tenets of corporate governance can be applied to banks, the relevance of banks in the financial system and the special attributes of opacity, complexity and heavy regulation inherent in banking business makes the problems and practice of corporate governance highly specific as are the mechanisms available to deal with such problems. (Ciancanelli & Reyes, 2001; Levine, 2004; Macey & O'Hara, 2003; Prowse, 1997)

Levine (2004) distinguishes two related characteristics of banks that make their governance distinctive. First, banks are more opaque than non-financial firms. In other words, informational asymmetries are larger in banks than all other sectors (Furfine, 2001; Macey & O'Hara, 2003 and Morgan, 2002). Bank opacity and complexity reflects the idiosyncratic nature of banking business and the difficulties outside stakeholders (for example, equity holders, debt holders, regulators and customers) face when trying to acquire reliable information about a bank's health status and operations. This opacity can take the form of loan quality not being easily observable, financial engineering not being transparent, risk composition of assets being altered and financial statements proving fictitious and complicated (Andres & Vallelado, 2008).

The second specific feature identified by Levine (2004), is that banks are frequently heavily regulated. The multiple regulation of banks by regulators most often distorts the behaviour of bankers and inhibits standard corporate governance practices. The main aim of the regulator is to reduce systemic risk in the system, and this often conflicts with the main goal of other stakeholders especially the shareholders, who are interested in the maximization of their share values (Jensen, 2001; Andres & Vallelado, 2008; Caprio et al., 2007).

Although it is true that monitoring by regulators represents an additional governance mechanism, their presence may further complicate governance problems in banks. For example, regulators might suppress competition in favor of some banks and discipline banks by imposing restrictions on ownership structures (Prowse, 1997; Macey & O'Hara, 2003). They can also intervene to limit the power of markets to control the banks (Ciancanelli & Reyes, 2001). In extreme cases, the regulators may even pursue their own interest as regulators (Santomero, 1997)

On the other hand, regulation can be viewed as an external corporate governance mechanism that acts macroeconomically at the banking industry level and macroeconomically at the individual banks' level to build confidence in the entire financial system.

Thus, the presence of heavy regulations, informational asymmetries, opaqueness and conflicts of stakeholder interests in banking business puts a special relevance on the internal corporate governance mechanisms which has the board of directors at its apex.

II.1 Theoretical Issues

Adam Smith (1776) appears to be the first economist to address the theoretical issue of the role of board of directors in the governance of a firm. He observed that because managers controlled people's money rather than theirs, it cannot be expected that they should watch over it with anxious vigilance as negligence and profusion will prevail.

Negligence and profusion in the management of a firm are the consequences of

the separation of stakeholder (ownership) from management (control) which is inherent in a modern corporation (John & Senbet, 1998; Hermalin & Weisbach, 2003; Gillan, 2006; Sanda et al., 2005). The separation of ownership from management in a typical Nigerian bank necessitates a Principal-Agent relationship. Here, the board of directors, professional managers, employees and corporate insiders are the agents on the one hand and the equity holders, creditors, clients and regulators are the principal on the other hand.

The agency theory states that in the presence of information asymmetry, the agent is likely to pursue interests that may be detrimental to the principal (Sanda et al., 2005). The reason for this is because the pay-off structure of the claims of different classes of stakeholders (including board of directors) is fundamentally different. The process of aligning these interests and claims gives rise to potential conflicts among the stakeholders. Left alone, each class of stakeholder will pursue its own interest which may be at the expense of other stakeholders and, hence, the need for a moderating instrument-corporate governance-in a modern firm.

Agency relationships in a firm can be classified on the basis of the interactions among particular parties in a firm. For example interactions between stockholders (principal) and management (agent) is referred to as managerial agency or Managerialism. Interactions between the agents of the public sector (e.g., CBN) and the rest of the society is termed political agency, whereas, interactions between the private sector and the public sector is known as social agency¹. Our focus here is, however, on managerial agency.

In recent times, the agency theory has been augmented to include analysis of the multiplicity of the agency relationships that exist among all stakeholders of a firm and this has come to be known as the stakeholder theory (Sanda et al., 2005). Jensen (2001) recognizes the implicit weakness of the stakeholder theory which requires that managers optimize a multiplex (i.e. multiple and complex) objective function. This condition violates the proposition that a single-value objective is a prerequisite for rational behaviour by any firm. In search of a solution, Jensen (2001) proposed the “enlightened stakeholder theory”, which specifies only one objective that managers should pursue: the maximization of the long-run value of the firm.

¹ See John & Senbet (1996, 1998) for a detailed classification of agency interactions.

We have overlooked the theory of the Fisherian Separation Principle as presented by John and Senbet (1998), because it idealizes the economy and firm and fails to recognize the special features of opaqueness, heavy regulations and informational asymmetries which are inherent in banking business.

Following the enlightened stakeholder theory as presented by Jensen (2001), we hypothesize the following:

1. In the presence of opacity, information asymmetry and heavy regulation in banks, larger bank boards lead to increased bank performance since large boards facilitates monitoring and brings more human capital to advise management.
2. Given the multiplicity of stakeholder interest, the admittance of more non-executive directors who are endowed with the prerequisite knowledge, incentives and abilities to monitor and advise management will alleviate the conflict of interest among stakeholders and improve bank value.
3. Finally, we posit that there is a positive link between the frequency of board meetings and bank performance.

II.2 Empirical Issues

A plethora of empirical works have examined the link between board structure and firm value (Gillian, 2006). Specifically, researchers have attempted to provide answers to the following questions: How effective is the board in performing its monitoring function (Adams & Ferreria, 2003; Andres & Vallelado, 2008; John & Senbet, 1998)? Does board composition matter (Sanda et al., 2005; Shleifer & Vishny, 1997; Andres & Vallelado, 2008; Bhagat & Bolton, 2008)? What is the structure and activity of board sub-committees (Klein, 1998; Klein, 2002; Deli & Gillian, 2000)? What is the role of CEO duality? That is, where the CEO doubles as chairperson of board (Baliga et al., 1996; Brickley et al., 1997; Goyal & Park, 2002; Raheja, 2005).

The two major characteristics of boards that stand out in the literature as having the greatest impact on board effectiveness and performance are: board size and board composition and the ratio of non-executive to total directors (Sanda et al., 2005; John & Senbet, 1998; Denis, 2001). With respect to board size, the hypothesis tested has generally been that smaller boards are more effective because they can hold more coordinated discussions, make decisions quickly and are less easily controlled by management (Denis, 2001). On the other hand, some authors have tested the hypothesis that larger boards are more effective because the large size facilitates intensive management supervision and brings more human capital to advise management (Caprio et al., 2007).

The inherent weakness in large boards is that too many members lead to problems of coordination, rigidity in decision making and excessive control of CEO, thereby harming efficiency (Yermack, 1996; Eisenberg et al., 1998). Thus the effect of board size (small or large) on bank value is a trade-off between advantages (effective monitoring and advising) and disadvantages (weak coordination, excessive control and rigidity in decision making). This trade-off shows up as a non-linear relationship between board size and bank value (Andres & Vallelado, 2008).

With respect to board composition, the generally tested hypothesis is that directors who are members of bank management or who are affiliated with those managers (commonly termed executive directors) are less effective as monitors and advisers of management than those directors who have no family or business ties with the bank management, that is, the non-executive directors

The literature emphasizes that it is not enough to skew the boards towards a concentration of non-executive (outside) members. Rather, it is important that the members be endowed with the prerequisite knowledge, incentives and abilities required to monitor, discipline and advise the managers (Harris & Raviv, In press). On the other hand, disproportionate concentration of non-executive directors may undermine the advisory and diffusion roles of the board since it limits the number of insider executives on the board; and insiders (executive directors) facilitate the diffusion of information and advice from the board to

management and members of staff (Coles et al., 2008).

Although the empirical evidence regarding the relationship between relative concentration of non-executive directors on boards and board performance is not conclusive, virtually all codes of good corporate governance practice recommends increasing their presence (Bhagat & Black, 2002; Coles et al., 2008).

The review of the literature on the determinants of bank board's effectiveness will be incomplete if we do not examine the internal functioning and characteristics of the boards. Larcker et al. (2005) conducted a study on board interlocks and concluded that 'cozy' (friendly) board relationships limit effective monitoring. In the same light, Fich & Shivdasani (2006), suggest that the board's ability to monitor is compromised in firms with several busy directors. In a similar manner, Vafeas (1999) examined the frequency of board meetings and found explanations both for and against a positive relationship between the frequency of board meetings and firm performance. Meetings provide an avenue for board members to converge and map out strategies on how to monitor managers and operations of the bank. Hence, the more frequent the meetings, the more proactive the board is, setting standards and providing participatory leadership. On the other hand, fewer meetings will suggest an anticipatory board only responding to issues and events (reactive).

Another important variable that influences the effectiveness of boards is the compensation structure operational in the banks. Brick et al. (2006) analyzed the link between board and CEO pay. After controlling for CEO age, tenure, ownership, board size, among others, the authors concluded that excess compensation for directors compromises their independence and leads to overpayment of CEO; a situation which they refer to as 'cronyism,' that is, mutual back-scratching. Also, committee structure and the expertise of board members prove to be an explanatory variable in determining the effectiveness of boards. The presence of financial expertise on boards limits the likelihood of accounting scams and builds market credibility to earnings and profit announcements of banks (Anderson et al., 2005; Agrawal & Chadha, 2006; Gillan, 2006).

In addition, the institutional framework within which bank boards operate has attracted much attention. The interaction of the boards with the laws, regulations,

capital markets, labor markets, product market and the socio-political environment shapes the likelihood of failure or success of the boards. Caprio et al. (2007) show in their study, the importance of legal and institutional rather than regulatory mechanisms in banking governance. In the same vein, Beck et al. (2006) showed that empowering private monitoring of banks yields the greatest benefits in developed countries that have in place legal and institutional systems that work well. However, the case may be different in a developing country like Nigeria with weak institutions.

III. Corporate Governance in the Nigerian Banking Sub-Sector

Corporate governance of banks in Nigeria is principally shaped by the interaction of the following factors: the legal framework, the regulatory institutions, the financial system and the banking environment. Generally, the legal underpinnings for enforcing the practice of corporate governance in banks is stipulated in the following permissible frameworks: the Central Bank of Nigeria (CBN) Act, 2007; Banks and Other Financial Institutions Act (BOFIA), 1991 (As amended); the Nigerian Deposit Insurance Corporation (NDIC) Act, 2006; the Companies and Allied Matters Act (CAMA), 1990; and the Economic and Financial Crimes Commission (EFCC) Act, 2004. These legal documents and other internally generated codes by the banks provide the framework for identifying best practice codes and enforcing the compliance with such codes.

Before the banking sector consolidation, quite a number of banks examined had revealed severe weaknesses in their corporate governance standards. For instance; many banks were family owned, so much so that the chairpersons doubled as Chief Executive Officers (CEOs). These weaknesses in corporate governance practice were evidenced in the high turnover of board and management staff, gross insider abuses which resulted in huge non-performing insider related credits, financial engineering, non-compliance with regulatory requirements, falling ethics, and de-marketing other banks (Kama, 2006). In particular, free, unrestrictive equity holding led to serious abuses by individuals, family members and governments. Generally, there was public call for changes in the structure and organization of bank boards in the industry, particularly after the consolidation exercise.

In order to encourage private sector led economy as well as imbibe a good corporate governance culture, “Code of Corporate Governance for Banks in Post Consolidation” was issued in 2006 and banks were obligated to comply with the tenets of the Code, including the “Code of Corporate Governance for Nigeria,” issued by SEC.

The following are highlights of the codes of corporate governance for banks in post consolidation, issued by the CBN:

Equity Ownership

- Government's direct and indirect equity holding in any bank shall be limited to 10%.
- Any equity holding of above 10% by any investor is subject to CBN's prior approval.
- Directors or significant shareholders should not borrow more than 10% of the bank's paid-up capital without the prior approval of the CBN. The maximum credit to all insiders should not exceed 60% of the bank's paid up capital.

Organizational Structure

- The responsibilities of the head of Board, that is, the Chairman, should be clearly separated from that of the head of Management, i.e. MD/CEO.
- There should be, as a minimum, the following board committees: Risk Management Committee, Audit Committee, and Credit Committee.
- The number of non-executive directors should be more than that of executive directors, subject to a maximum board size of 20 directors.
- At least (2) non-executive board members should be independent directors (who do not represent any particular shareholder interest and hold no special business interest with the bank) appointed by the bank on merit.

Board Performance and Appraisal:

- Each board should identify and adopt, in the light of the company's future

strategy, its critical success factors or key strategic objectives.

- There should be annual Board and Directors' review/appraisal covering all aspects of the Board's structure and composition, responsibilities, processes and relationships, as well as individual member's competencies and respective roles in the Board's performance.

Quality of Management:

- Appointment to top management positions should be based on merit rather than some other considerations.
- Track record of appointees should be an additional eligibility requirement. Such records should cover both integrity ('fit and proper' as revealed by the CBN 'blackbook', CRMS etc) and past performance (visible achievements in previous place(s) of work).

Reporting Relationship

- Officers should be held accountable for duties and responsibilities attached to their respective offices.
- The structure of any bank should clearly define acceptable lines of responsibility and hierarchy; and
- All insider credit applications pertaining to directors and top management staff (AGM and above) and parties related to them, irrespective of size, should be sent for consideration and approval to the Board Credit Committee (BCC), among others.

Recently, the compliance rating of deposit money banks to the laid down codes of corporate governance in Nigerian had received a triple 'A' rating, following the adoption of the new code (Phillips, 2007). Many banks are now responding by carrying out board reforms which are typically in the forms of increasing the relative proportion of non-executive directors, separating the position of Chief Executive from Chairperson, increasing board size and requiring board members to have block holdings, among others (Inam, 2006). These internally engineered board reforms have proved to be beneficial as banks now enjoy ease of raising capital, improved business performance, increased customer satisfaction,

strategic business alliances and improved financial reporting systems (Phillips, 2007; Kama, 2006).

Despite the above positive developments, corporate governance in Nigerian banks is still confronted by a myriad of challenges. Ibrama (2007) views the technical incompetency of boards and management, acrimonious relationships among directors, increased levels of risk, rendition of false returns, poor integration and development of ICT, accounts and records systems, resurgence of high level malpractices and ineffective integration of entities as the major challenges facing Nigerian banks in their bid to comply with 'best practices' of corporate governance. Also, Alo (2007), highlighted some of the challenges faced by Nigerian banks including: the challenge of: enlightening stakeholders, putting in place the appropriate institutional framework, achieving value reorientation, breaking the poverty trap and bridging the inefficiencies of governance bureaucracies. It is envisaged that tackling these challenges will create an enabling environment for Nigerian banks to maintain full compliance with the laid down tenets of good corporate governance in Nigeria.

As basic prerequisites for the successful practice of good corporate governance in Nigerian banks, the societal norms and standards relating to accountability, democratic values, the rule of law, attitudes towards the generation and acquisition of wealth and the effectiveness of the supervisory and judicial system will have to be improved upon to ensure zero tolerance for defaulters.

IV Sample, Variables and Econometric Model

In this section, we describe the sample and variables used in the model. We also describe the measurement techniques adopted as well as the econometric model used. We have kept the presentation simple and concise to facilitate understanding.

IV.1 Data and Sample:

We selected 19 banks out of the total of 24 banks in Nigeria; representing about 79.2 per cent of the entire bank population. Our selection is not based on any probabilistic technique but on the consistency and availability of the required

data. The analysis covers the period between 2000 and 2008. Incidentally, this period coincides with the banking sector consolidation exercise which was conducted between July 2004 and December 2005. We recognize that this may have structural effects on our model and have adequately controlled for same.

All the data used for the analysis were extracted from the annual and financial reports of the respective banks and the Annual Fact Books of the Nigerian Stock Exchange (NSE).

IV.2 Variables and Measurement:

We proxy board effectiveness by using bank performance, hence we adopted the Tobin's Q ratio as our prime indicator of bank performance. Following Coles et al. (2008), we approximate Tobin's Q as book assets minus book equity plus market value of equity all divided by the book value of assets. Many other studies on board effectiveness have used this variable as the dependent variable (Sanda et al., 2005; Caprio et al., 2007; Bhagat & Black, 2002; Andres & Vallelado, 2008).

We measure the size, composition and functioning of boards with the variables *BOARDSIZE*, *OUTSIDER* and *MEETYR*, respectively. *BOARDSIZE* is the board size. That is, the number of persons sitting on the boards. *OUTSIDER* represents board composition. That is, the balance between executive and non-executive directors. We measure it by finding the proportion of non-executive (outside) directors in total number of directors. Whereas we used *MEETYR* to measure board proactiveness (functioning). *MEETYR* simply represents the number of meetings held by the board each year as indicated in their annual reports.

We further construct a set of control variables to account for the following: bank size, whether or not the bank merged during the consolidation, whether or not the CEO was the promoter of the bank, the nature of the banks' business and period dummies.

The first group of control variable checks for relative bank size, we denote this by *BNKSIZE* and we measure it by taking the natural logarithm of the total assets of the respective banks. Another group of control variable which accounts for business fusion is *BNKMERGE*. This distinguishes between banks that

exclusively merged and those that did not merge during the consolidation era. We assign a value one (1) to those banks that are the outcome of merger arrangements and zero (0) to those that stood alone.

A third group of control variables that checks for bank business structure is LONASS. It is constructed as the ratio of loans and advances to total assets at book value. To account for differences in bank ownership structure, we introduce the control variable CEOP. This accounts for whether or not the CEO started the bank. We assign the value one (1) to banks with CEO as promoter and zero (0) to others.

To check for robustness of results, we employ another alternative measure of bank performance as dependent variable: the Return on Assets (ROA). We calculate the Return on Assets by finding the percentage of net profit in total assets².

IV.3 Econometric Model and Estimation Technique:

Building on Andres and Vallelado (2008) and Sanda et al. (2005), we specify a model establishing the link between board 'effectiveness' and bank performance with a non-linear relation on board size thus:

$$\begin{aligned} \text{PERFORMANCE}_{i,t} = & \beta_0 \pm \beta_1 \text{BOARDSIZE}_{i,t} \pm \beta_2 \text{BOARDSIZE2}_{i,t} \pm \beta_3 \text{OUTSIDER}_{i,t} \\ & \pm \beta_4 \text{MEETYR}_{i,t} \pm \beta_5 \text{BNKSIZE}_{i,t} \pm \beta_6 \text{BNKMERGE}_{i,t} \\ & \pm \beta_7 \text{LONASS}_{i,t} \pm \beta_8 \text{CEOP}_{i,t} \pm \beta_9 \text{YEAR}_{i,t} \pm \delta_t \pm \gamma_t \pm \mu_{i,t} \end{aligned} \quad (1)$$

All the variables in equation (1) are as already defined and the i 's represent banks 1 through 19. The t takes values of the years from 2000 to 2008. The β parameters represent the constant term and the estimated coefficient for their respective variables. We split the error term into three components: δ_t is the time effect which controls for macroeconomic shocks, γ_t is the individual effect which controls for unobservable heterogeneity and $\mu_{i,t}$ is the stochastic disturbance.

We adopted the panel data analysis technique because of the pooled nature of the data set (mixture of time series and cross section) and its ability to take into account the unobservable and constant heterogeneity effects inherent in the data

² In most cases, these variables are directly reported in the Annual Reports.

set. Given that some of our explanatory variables such as board size, composition and functioning may be determined simultaneously with bank performance (Hermalin & Weisbach, 2003), it simply implies that we are likely to have problems of endogeneity.

The general approach to estimating models that do not strictly satisfy the exogeneity condition is to use a transformation to eliminate the unobserved effects and introduce instrumental variables to deal with endogeneity (Wooldridge, 2002). Thus, we adopted Arellano & Bond's (1998) proposal to use the two-step system estimator with adjusted standard errors for potential heteroskedasticity. The itinerary of this method considers the unobservable effects, transforming the variables into first differences and uses the generalized method of moments (GMM) with instrumental variables to deal with endogeneity problems.

We used the lags of *BOARDSIZE*, *OUTSIDER* and *MEETYR*, *PERIOD* dummies and Tobin's *Q* as our instrumental variables. To test for model specification, we employ the J-statistic to test for overidentification of restrictions and to examine the correlation between the instruments and the error term. Before proceeding to estimate the model using the Generalized Method of Moments (GMM) we used Windmeijer (2000) adjustment for small samples to avoid any potential downward bias in the estimated asymptotic standard errors and to improve the robustness of our results.

V. Results and Its Implications

In this section we present descriptive statistics of the data used for the analyses. This is to aid the reader better appreciate the prevailing board design and performance indices in Nigerian banks. We also present the results of the Dynamic Panel Data (DPD) analyses using the Generalized Method of Moments (GMM) with the two-step system estimator which improves on previous empirical researches by accounting for the unobserved heterogeneity, and chiefly the endogenous nature of our explanatory variables.

V.1 Descriptive Synopsis:

Table 1 depicts a summary of the descriptive statistics of our variables. Each variable has 171 observations which represent data for 19 out of 24 Nigerian banks between the years 2000 and 2008.

Table 1. Summary Statistics

Variable	Mean	Median	Std. Dev	Skwn.	Max.	Min.	Obs.
<i>Board Structure</i>							
BOARD SIZE	13.07	12.00	3.26	0.62	20.00	8.00	171.00
OUTSIDERS	0.51	0.58	0.09	0.44	0.60	0.37	171.00
MEETYR	6.72	7.00	1.97	0.60	12.00	3.00	171.00
BOARD SIZE SQ.	180.43	144.00	92.32	1.07	400.00	64.00	171.00
<i>Bank Characteristics</i>							
BNKSIZE	27.03	27.55	1.65	-1.75	29.51	20.06	171.00
LONASS	0.35	0.33	0.11	0.00	0.55	0.10	171.00
<i>Bank Performance</i>							
Tobin's Q	1.21	1.14	0.20	2.09	1.90	-0.04	171.00
ROA	2.22	1.90	0.82	0.78	4.00	1.00	171.00

From the Table, we observe that the mean and median sizes of bank boards in Nigeria are 13.07 and 12, respectively. This is significantly higher than the average and median sizes of 8.45 and 6 reported for non-financial firms in Nigeria (Sanda et al., 2005). Our measure of board composition (OUTSIDER) reveals that on average, 51 per cent of board members in Nigerian banks are non-executive directors. Since the median board size consists of 12 members, it implies that a typical Nigerian bank has about six non-executive and six executive directors. The number of meetings held by boards in a year which is our proxy for board proactiveness indicates that on average, bank boards hold meetings 6.72 times a year. With a positive skew of 0.6, we conclude that most banks boards, hold meetings more than six times a year.

Our measure of the structure of bank business (BNKSIZE) which we constructed as the natural log of a bank's total assets (a control variable) indicates a mean and median of 27.03 and 27.55 with a negative skew of -1.75 and 1.65 standard

deviation, suggesting that there are more banks with relatively smaller total assets than a few with relatively very large assets.

A second control variable (LONASS) which is constructed as the ratio of loans and advances to total assets indicates an average of 0.35, implying that an average Nigerian bank has about 35 per cent of its total assets in loans and advances. This is less than the average of 49 per cent reported for selected OECD countries by Andres & Vallelado (2008).

Our measures of performance (TOBIN'Q and ROA) reveal averages of 1.21 and 2.22 per cent, respectively. Both averages are significantly higher than 1.15 and 1 per cent reported for banks in selected developed countries (Andres & Vallelado, 2008).

V.2 Two-Step System Estimation Results

In Table 2, we report the results of our estimation. We indicate the estimated coefficients of the variables with their corresponding probability values. We show the J-statistic which we used to test for the validity of over-identifying restrictions, we also presented the first and second order autocorrelation test and the F test of overall model statistical significance.

The results of our estimation do not reject the rationality of our model and confirms the absence of first and second-order serial correlation. The suitability of our instrument list which takes care of endogeneity is confirmed by the J-statistic.

We observed a positive and significant relation between BOARDSIZE and both measures of bank performance. The implication is that the admittance of additional members into the board improves bank performance though with a diminishing marginal growth. This result is consistent with the hypothesized inverted U-shaped relation between board size (BOARDSIZE) and bank performance (TOBIN'Q or ROA) as presented in Andres & Vallelado (2008).

Table 2. Estimated Relationship between Board Structure and Bank Performance in Nigeria.

Independent and Control Variables	TOBIN's Q		ROA	
	Coef.	P> t	Coef.	P> t
BOARDSIZE	0.0894	0.014**	0.6250	0.0413**
BOARDSIZE SQ.	-0.0037	0.0457**	-0.0266	0.0298**
OUTSIDER	0.0177	0.0454**	0.2224	0.0173**
MEETYR	-0.0555	0.0565*	-0.0395	0.0902*
BNKSIZE	0.0104	0.0919*	-0.3269	0.5852
LONASS	-0.1878	0.0894*	-7.6045	0.0185**
BNKMERGE	-0.2467	0.8337	-10.2176	0.3602
PERIOD 02	0.0805	0.3440	0.2791	0.6104
PERIOD 03	0.0312	0.0824*	-0.5822	0.0308**
PERIOD 04	0.0629	0.0003***	-0.1014	0.0779**
PERIOD 05	-0.0801	0.0492**	1.2504	0.0366**
PERIOD 06	0.0591	0.3152	-0.4572	0.2943
PERIOD 07	0.0387	0.5233	0.0130	0.9744
PERIOD 08	-0.0369	0.0741*	0.5375	0.2108
OPT. BOARDSIZE	14.0000		13.0000	
<i>F</i> test	19.7601	0.0000***	23.9204	0.0000***
J-Statistic	5.2857	0.6163	5.3561	0.0000***
AR_t	-0.9305	0.3060	-0.9841	0.3082
AR_2	-0.6803	0.4869	-0.7106	0.5106

* (**) and (***) denotes rejection of the hypotheses at 10%, 5% and 1% significance level respectively

The negative and significant coefficient for the square of board size (BOARDSIZE SQ) suggests that there is an optimum point at which admitting a new director reduces bank performance. For Nigerian banks, the optimum number is between thirteen and fourteen members. We note that this is the board size that maximizes the objective function.

We observed a positive and significant relationship between the proportion of non-executive directors (OUTSIDER) and bank performance. This result is consistent with the theory and validates the argument that admitting non-executive directors into the board improves its monitoring and advisory role to management and helps to align the interests of various classes of stakeholders.

Unlike the traditional results in previous empirical researches, we observed a negative and significant relationship between bank board meeting and bank performance. This result suggests to us that frequent meetings by bank boards are a response to bank's poor performance, implying that the boards rather than being proactive are reactive to poor performance, thereby meeting often to design, monitor and advise management on strategies to adopt.

Precisely, our results point to the relevance of corporate governance variables in determining bank performance in Nigeria. Therefore, our results confirm the view that some bank board characteristics (size, composition and proactiveness) may be associated with either effectiveness or ineffectiveness in the discharge of its monitoring and advisory role to management.

VI. Policy Implications, Directions for Future Research and Concluding Remarks

In this section, we present policy options available to stakeholders of the banking industry in Nigeria. We also present directions for future research on corporate governance and its relation to bank performance and end with some concluding remarks.

Policy Implications

To guarantee the maximization of shareholder's value and, hence, economic growth, bank boards should be 'efficiently' sized. Stakeholders should engage researchers to obtain the optimum size of boards that achieves the objective function for their respective industries and size their boards plus or minus two standard deviation of the optimum value. In our case, the optimum size of bank boards in Nigeria is 13. Therefore, for any Nigerian bank to operate anywhere around the optimum the board size should be between 11 and 15.

To ensure that bank boards are efficient and that there is minimal or no conflict between the various classes of stakeholders and management, bank boards should have the optimal mix of directors. From our results, a relatively balanced mix (equal number of executive and non-executive members) as against the prevailing code which states that the number of non-executive directors should be more than that of executive directors subject to a maximum of 20 directors, will be the recommended combination. As a prerequisite, an implementable legal framework must be put in place to govern the contractual agreements between stakeholders and boards of directors. For instance, all board members can be made to sign a bond that specifically stipulates their roles in the agency agreement which includes ensuring the maximization of the objective function of the bank.

Further, stakeholders (including regulators) have the option of motivating board members to be more efficient by providing incentive packages to induce board members to act in desired ways³. Also, stakeholders may decide to monitor board members directly or indirectly by engaging consultants to do the monitoring were they do not have the expertise to do so.

Directions for Future Research:

In the course of this study, we observed that there is a relative dearth of theoretical and empirical work on corporate governance and bank performance in underdeveloped and emerging economies. The fragility of emerging and underdeveloped economies put a special relevance on the applicability of good corporate governance mechanisms, especially in banks. There is need for researchers to beam their search light on the impact of socio-political shocks on the corporate governance of banks and non-financial firms.

It is also of relevance that we focus on understanding the interaction among multiple governance mechanisms. That is, incorporating traditional means of governance such as social, cultural, family and religious dimensions to the governance of banks (firms). This will greatly improve our knowledge of corporate governance, especially in emerging markets that have strong ties with social systems.

Importantly, from a fundamental viewpoint, there is a strong need to further

³ See Denis (2001) for details of possible incentive packages for board members

develop structural models and quantitative theories of the firm to guide future empirical work.

Lastly, there is a strong requirement for a unified corporate body saddled with the responsibility of collecting and collating corporate governance related data in emerging markets and constructing the relevant indices to facilitate corporate governance research in emerging markets like Nigeria.

Concluding Remarks

In the corporate governance of banks, banks' board of directors play a significant role by monitoring and advising management on the formulation and implementation of strategies. Our hypothesis was that certain characteristics of bank boards (size, composition and proactiveness) determine the effectiveness of the board in carrying out its monitoring and advisory roles.

After controlling for heterogeneity and endogeneity using the two-step system estimator, we found that admitting new board members improves bank performance up to a certain point, 'efficient limit', where continuous increase of the board size begins to destroy value. We also obtained empirical evidence which agreed with popular codes of good corporate governance practice, that is, increasing the proportion of non-executive directors in the board improves bank value.

Our third finding challenges the widespread belief that frequent board meetings play a role that was more proactive than reactive. We observed an inverse relationship between board meetings and bank performance which suggests to us that bank boards that meet more often are only reacting to the bank's poor performance. All our findings were consistent after controlling for ownership structure (CEOP), bank size (BNKSIZE), and the effect of the 2004 regulatory shock (BNKMERGE).

Finally, bank boards strategically alleviate the problems of governance in banks and reduce the weakness of other corporate governance mechanisms (especially the regulatory and external governance mechanisms). Hence, empowering boards through incentives packages and an enlarged purview of authority and responsibility to monitor, sanction, reprimand and advise management will be the way forward for the growth and development of the banking sub-sector in Nigeria.

References

- Adam, R., Mehran, H. (2005). "Corporate Performance, Board Structure and Its Determinants in the Banking Industry." *SSRN Working Paper*.
- Adams, R., & Ferreria, D. (2003). "A Theory of Corporate Boards". *Working Paper, SITE-Stockholm School of Economics*.
- Adams, R., & Mehran, H. (2003). "Is Corporate Governance Different for Bank Holding Companies?" *FRBNY Economic Policy Review*, 9(1), 123-142.
- Agrawal, A., & Chadha, S. (2006). "Corporate Governance and Accounting Scandals". *Journal of Law and Economics*, 48, 371-406.
- Alo, Olamideji (2007) "Corporate Governance in Nigeria: An Overview" *CBN Bullion*, 31(3), 1-6.
- Anderson, R., Deli, D., & Gillan, S. (2005). "Board of Directors, Audit Committees and the Information Content of Earnings". *Working Paper, Arizona State University*.
- Andres, P., & Vallelado, E. (2008). "Corporate Governance in Banking: The Role of the Board of Directors." *Journal of Banking and Finance*, 2570-2580.
- Arellano, M., & Bond, S. (1998). Dynamic Panel Estimation Using DPD98 for GAUSS: A Guide for Users. *Working Paper, Institute For Fiscal Studies*
- Baliga, B., Moyer, R., & Rao, R. (1996). "CEO Duality and Firm Performance: What's the Fuss?" *Strategic Management Journal*, 17, 71-92.
- Beck, T., Demirguc-Kunt, A., & Levine, R. (2006). "Bank Spervision and Corruption in Lending". *Journal of Monetary Economics*, 53, 2131-2163.
- Bhagat, S., & Black, B. (2002). "The Non-Correlation between Board Independence and Long-Term Firm Performance". *Journal of Corporation Law*, 27, 231-274.
- Bhagat, S., & Bolton, B. (2008). "Corporate Governance and Firm Performance." *Journal of Corporate Finance*, 14, 257-273.
- Boot, A., & Thakor, A. (1993). "Self Interested Bank Regulation." *American Economic Review*, 83, 206-212.

- Brick, I., Palmon, O., & Wald, J. (2006). "CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?" *Journal of Corporate Finance*, 12, 403-423.
- Brickley, J., Coles, J., & Jarrell, G. (1997). "Leadership Structure: Separating the CEO and Chairman of the Board." *Journal of Corporate Finance*, 3 (3), 189-220.
- Caprio, G., Laeven, L., & Levine, R. (2007). "Governance and Banks Valuation." *Journal of Financial Intermediation*, 584-617.
- Central Bank of Nigeria (2006) *Code of Corporate Governance for Banks in Nigeria Post Consolidation*. CBN Abuja.
- Ciancanelli, P., & Reyes, J. (2001). "Corporate Governance in Banking: A Conceptual Framework". *SSRN Working Paper*.
- Coles, J., Naveen, D., & Naveen, L. (2008). "Boards: Does One Size Fit All"? *Journal of Financial Economics*, 87, 329-356.
- Deli, D., & Gillian, S. (2000). "On the Demand for Independent and Active Audit Committees." *Journal of Corporate Finance*, 6(2) 427-445.
- Denis, D. (2001). "Twenty-Five Years of Corporate Governance Research... and Counting." *Review of Financial Economics*, 10, 191-212.
- Eisenberg, T., Sundgren, S., & Wells, M. (1998). "Larger Board Size and Decreasing Firm Value in Small Firms." *Journal of Financial Economics*, 43, 35-54.
- Fich, E., & Shivdasani, A. (2006). "Are Busy Boards Effective Monitors?" *Journal of Finance*, 61 (2), 689-724.
- Furfine, C. H. (2001). "Banks as Monitors of Other Banks: Evidence from the Overnight Federal Funds Market." *Journal of Business*, 74, 33-57.
- Gillan, S. (2006). "Recent Developments in Corporate Governance." *Journal of Corporate Finance*, 12, 381-402.
- Gillan, S., & Starks, L. (1998). "A Survey of Shareholder Activism and Motivation: An Empirical Evidence." *Contemporary Finance Digest*, 2 (3), 10-34.

- Goyal, V., & Park, C. (2002). "Board Leadership Structure and CEO Turnover". *Journal of Corporate Finance*, 8, 49-66.
- Harris, M., & Raviv, A. (2005). "A Theory of Board Control and Size." *Working Paper, University of Chicago*. Chicago.
- Harris, M., & Raviv, A. (In press). "A Theory of Board Control and Size." *Review of Financial Studies*.
- Hermalin, B., & Weisbach, M. (2003). "Board of Directors as an Endogenously Determined Institution: A Survey of Economic Literature." *FRBNY Economic Policy Review*, 7-26.
- Hermalin, B., & Weisbach, M. (1998). "The Determinants of Board Composition." *Rand Journal of Economics*, 19 (4) 589-606.
- Ibrama, Ada. (2007). "Corporate Governance" A Lecture Presented to staff of Banking Supervision at the CBN Head Office Building.
- Inam, W. (2006). "Regulatory and Institutional Challenges of Corporate Governance in Nigeria Post Banking Consolidation." *Nigerian Economic Summit Group, Economic Indicators*, Vol. 12 No. 2. Abuja.
- Jensen, M. (1993). "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems." *Journal of Finance*, 48, 831-880.
- Jensen, M. (2001). "Value Maximization, Stakeholder Theory, and the Corporate Objective Function." In D. Chew, & S. Gillan, *Corporate Governance at the Crossroads: A Book of Reading*. New York: McGraw-Hill.
- John, K., & Senbet, L. (1996). "Limited Liability, Corporate Leverage and Policy." *Working Paper, New York University*.
- John, K., & Senbet, L. (1998). "Corporate Governance and Board Effectiveness." *Journal of Banking and Finance*, 22, 371-403.
- Kama, U. (2006). "Recent Reforms in the Nigerian Banking Industry: Issues and Challenges" *CBN Bullion*, 30 (3) 65-73

- Klein, A. (1998). "Firm Performance and Board Committee Structure." *Journal of Law and Economics*, 137-165.
- Klein, A. (2002). "Economic Determinants of Audit Committee Independence." *Accounting Review*, 77, 435-452.
- Larcker, D., Richardson, S., Seary, A., & Tuna, A. (2005). "Back Door Links between Executives and Executive Compensation." *Working Paper, The University of Pennsylvania*.
- Levine, R. (2004). "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence." *World Bank Policy Research Working Paper*.
- Macey, J., & O'Hara, M. (2003). "The Corporate Governance of Banks." *FRBNY Economic Policy Review*, 91-107.
- Morgan, D. (2002). "Rating Banks: Risk and Uncertainty in an Opaque Industry." *American Economic Review*, 92, 874-888.
- OECD (1999), "OECD Principles of Corporate Governance" OECD, New York.
- Phillips, Toyin (2007) "Issues in Corporate Governance in the Banking Sector" *CBN Bullion*, 31(3), 7-16.
- Prowse, S. (1997). "Corporate Control in Commercial Banks." *Journal of Financial Research*, 20, 509-527.
- Raheja, C. (2005). "Determinants of Board Size and Composition: A Theory of Corporate Boards." *Journal of Financial and Quantitative Analysis*, 40 (2) 283-306.
- Sanda, A., Mikailu, A., & Garba, T. (2005). "Corporate Governance Mechanisms and Firm Financial Performance in Nigeria." *African Economic Research Consortium, Research Paper 149*.
- Santomero, A. M. (1997). "Effective Financial Intermediation." In K. B. Staking, *Policy-Based Finance and Alternatives: East Asian Lessons for Latin America and the Caribbean*. Washington, DC. Inter-American Development Bank.
- Shleifer, A., & Vishny, R. (1997). "A Survey of Corporate Governance." *Journal of Finance*, 52, 737-775.

- Smith, A. (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations*, New York, Modern Library.
- Vafeas, N. (1999). "Board Meeting Frequency and Firm Performance." *Journal of Financial Economics*, 53, 113-142.
- Windmeijer, F. (2000) "A Finite Sample Correction for the Variance of Linear Two-Step GMM Estimator." *Working Paper: The Institute for Fiscal Studies*.
- Wooldridge, J. M. (2002). *Econometric Analysis of Cross Section and Panel Data*. Cambridge, M.A: MIT Press.
- Yermack, D. (1996). "Higher Market Valuation of Companies with Small Board of Directors." *Journal of Financial Economics*, 40, 185-211.
- Zingales, L. (1998). "Corporate Governance", in P. Newman (eds), *The New Palgrave Dictionary of Economics and the law*, MacMillian, NY PP.497 503.