Impact of Corporate Governance Mechanisms on Asset Quality of Selected Deposit Money Banks in Nigeria

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Abstract

Good corporate governance practice is required for effective management of organizational resources and in the banking industry in particulars. Long after the initiative of CBN introducing corporate governance code following the consolidation exercise in 2005, efforts aimed at improving corporate governance practice in Nigerian banking industry has not yield the desired result. It is against this backdrop that the study examines the impact of corporate governance mechanisms on the asset quality of selected deposit money banks in Nigeria for a period of ten (10) years. Data for the study were quantitatively generated as retrieved from the annual financial reports and accounts of some selected deposit money banks in Nigeria. Data was analysed using regression analysis and it was discovered that audit committee and board composition contributes positively and significantly to assets quality of the deposit money banks in Nigeria. The study however, recommends among others that more efforts should be made to ensure adequate compliance to the reforms and to adhere to corporate governance principles, as well as its attractiveness and effectiveness towards improving performance.

Keywords: Corporate Governance, Audit Committee, Board Size, Board Composition, Firm Size and Assets Quality

1. Introduction

In recent times, corporate governance has become a topical issue which has attracted the attention of academic scholars and practitioners. Revelations of corporate fraud all over the world in the past years have clearly shaken investors' confidence and historical antecedents in financial practices have indicated that financial crisis is the direct consequence of poor corporate governance. These problems transferred to other parts of the world through globalization which makes countries of the world to be interconnected as a result of trade liberalization and advancement in technology (telecommunication and transportation). Africa particularly Nigeria had its own share of the contagious financial crises. In the recent past, financial institutions in Nigeria witnessed untold financial distress in which banks that were considered healthy by investors happened to be the most distressed. This made the Securities and Exchange Commission (SEC) in 2003 to posit that, the financial sector attracted poor corporate governance because only 40% of companies including banks quoted in the exchange had recognized code of corporate governance. Subsequently, in 2003, the Nigerian Securities and Exchange Commission rolled out a code of best practices on corporate governance for all public quoted companies. The banking sector crisis remained a subject of concern, because of its role in facilitating and stimulating economic development. This however made the apex bank (Central Bank of Nigeria) to take a bold step in revitalizing the banking sector through the stipulation of N25 billion naira capital base for all banks in Nigeria. This led to the emergence of 25 Commercial Banks in Nigeria as at 31st December, 2005 (Akpan, 2011). In 2006, the Central.

Bank of Nigeria issued a code of corporate governance to complement the existing one and the provisions of the new code were said to be indispensable in achieving viable and successful banking practice.

Since the issuance of the code of corporate governance by the CBN, efforts have been made to evaluate its impact on the performance of banks. From empirical perspective, efforts aimed at studying the impact of corporate governance among scholars have yielded varying outcome where a consensus is yet to be reached. This led to continuous study in the area of corporate governance and the performance of banks in the post consolidation era. While a number of performance measures were used by previous authors such as Net Interest Margin (NIM), financial reporting quality and earnings management, financial performance, assets quality has not been given the desired attention in the literature particularly in Nigerian studies.

It is based on this vacuum created by previous studies that this study intends to fill by examining the impact of corporate governance mechanisms on assets quality of selected deposit money banks in Nigeria.

The main objective of this study is to analyze the impact of corporate governance mechanisms on assets quality of deposit money banks in Nigeria. The specific objectives of the study are:

i. To examine the effect of board size on the asset quality of listed Deposit Money Banks in Nigeria;

ii. To investigate the effect of firm size on the asset quality of listed Deposit Money Banks in Nigeria;
iii. To assess the effect of audit committee on asset quality of listed Deposit Money Banks in Nigeria;
iv. To evaluate the effect of board composition on asset quality of listed Deposit Money Banks in Nigeria.

In line with the research objectives, the null hypotheses tested in this study are:

Ho_1: Board members' shareholding has no significant impact on firm performance.

Ho_2: The composition of the Board members has no significant influence on the performance of the firms.

Ho_3: The size of the Board of Directors has no significant influence on the performance of the organization.

Ho_4: There is no significant influence of institutional shareholding on firm performance in telecommunication industry in Nigeria.

2. Literature Review

Concept of Corporate Governance and Assets Quality

Corporate governance is a vital concept that relates to the manner in which material, finances, and human resources accessible to an organization are carefully used to achieve the general corporate objectives of an organization. According to Oluyemi, (2016) the importance of corporate governance cannot be taken lightly as it keeps the organization in business and creates a greater prospect for future opportunities. The general consequence of good corporate governance is to strengthen investors' poise in an economy. Corporate governance is thus about inculcating credibility, guaranteeing transparency and accountability as well maintaining an effective network of information disclosure that would nurture good corporate performance (Sani & Ali, 2017).

Craig (2015) defined corporate governance as a group of mechanism that stakeholders use to guarantee that directors effectively manage corporate resources. Abata, (2014) see corporate governance from the investors' perspective as both the promise to repay a fair return on capital invested and the commitment to operate a firm, efficiently in a given investment. Corporate Governance is largely concerned with governing the relationship between shareholders and directors. He further opined that the concept of corporate governance is primarily concerned with the process of customs, policies, systems, laws and regulations as being applied in organizations. In this regard, it is defined as the structure of relationships within the entity for making decisions and implementation.

Asset quality is the classification of credits according to the probability of repayment which estimates the amount of loss that will probably be suffered on deteriorating credits. The banking business is not insusceptible from this market tendencies as their products in trade is money which are monies collected in from depositors for onward lending to different sectors of the economy in forms of loans and advances. Nonetheless, DMBs' money creation process require adequate asset for existence, sustenance and development as it shapes the prosperity of the organization both on the short and long run basis (Abata, 2014).

Asset quality as a characteristic of bank management necessitates the appraisal of a firm's asset in order to enable the measurement of the level and size of credit risk associated with its operation. According to the Basle Committee on Banking Supervision, the fundamental principles of effective banking supervision comprised twenty-five core principles out of which seven are designed to address the relevant issues of bank asset quality or credit risk management (Sani and Ali, 2017). This inferred that asset quality is of universal imperative to financial supervisory establishments in every country across the world.

The challenges of asset quality is perhaps an imminent future time bomb for banks, if the canons for safety and soundness are not strictly adhered to as the various leaderships of the banking sector in Nigeria are found to have been violating the tenets of corporate governance. This necessitated the reforms that set up asset quality monitoring systems for identifying possible emerging problems of bank asset quality, and demanding banks to regularly present the asset quality reports to the board of directors so as to evaluate the risks associated with asset quality deterioration. This poor performance of bank asset quality affects the operating and financial performance as well as the general soundness of the financial system in which it is an entity. Oluyemi, (2016) opined that the deterioration of bank asset quality arising from the non-critical evaluation of loan quality is one of the immediate causes of the Nigerian financial Crisis.

It will be right to state that banking institutions around the world and especially in developing economies such as Nigeria with fragile banking systems should pay extra attention to the management of asset quality to ensure sound development of the banking industry. Considering that the Nigerian business environment is not completely immune from this global trends, the Central Bank of Nigeria (CBN) over the years has developed several measures aimed at providing a sound banking environment and safeguarding various stakeholders' interest with programmes and policies such as the bailing-out of some ailing banks, ensuring strict compliance with corporate governance principles in the entire financial system. But despite their efforts, the banking system continues to experience some hitches that erode investors' and depositors' confidence (Akingunola, Adekunle & Adedipe, 2013).

Audit Committee

The principles of corporate governance suggest that auditors should work independently and perform their duties with professional care. In case of any financial operation, the auditors are held responsible for their actions as the availability of transparent financial information reduces the information asymmetry and improves the value of a firm (Uwuigbe, 2011). In developing markets, auditors do not improve the value of a firm but rather manipulate the financial reports of the firms and serve the interests of the majority shareholders further disadvantaging the minority. The weak corporate law and different accounting standards also affect the performance of the auditors and create financial instability in the developing market (Uwuigbe, 2011).

Board of Directors' Composition

The board of directors can perform an imperative role in improving corporate governance and the value of a firm (Hassan, 2010). The value of a firm is also improved when the board plays its fiduciary duties such as monitoring the activities of management and selecting the staff for a firm. The board can also assign and monitor the performance of an independent auditor to improve the value of a firm. The board of directors can resolve internal conflicts and decrease the agency cost in a firm. The members of a board should also be accountable to the shareholders for their decisions (Uwuigbe, 2011).

The board consists of two types of directors; outsider (independent) and insider directors. The majority of directors in a board should be independent to make rational decisions and create value for the shareholders. The role of independent directors is important to improve the value of a firm as they can monitor the firm and can force the managers to take unbiased decisions. The independent directors can also play a role of a referee and implement the principles of corporate governance that protect the rights of shareholders (Olayinka, 2010).

Similarly, internal directors are also important in safeguarding the interests of shareholders. They provide the shareholders with important financial information, which will decrease the information asymmetry between managers and shareholders as argued by Umoh (2012). The board size should be chosen with the optimal combination of inside and outside directors for the value creation of the investors. The boards of directors in the developing market are unlikely to improve the value of a firm, as the weak judiciary and regulatory authority in this market enables the directors to be involved in biased decision-making that serves the interests of the majority shareholders and the politicians providing a disadvantage to the firm.

Board Size

Board size plays a significant role in affecting the value of a firm. The role of a board of directors is to discipline the CEO and the management of a firm so that the value of a firm can be improved. A larger board has a range of expertise to make better decisions for a firm as the CEO cannot dominate a bigger board because the collective strength of its members is higher and can resist the irrational decisions of a CEO as suggested by Adams and Mehran (2015). On the other hand, large boards affect the value of a firm in a negative fashion as there is an agency cost among the members of a bigger board. Similarly, small boards are more efficient in decision-making because there is less agency cost among the board members (Alo, 2017).

Firm Size

Firm size is measured using the natural logarithm of total assets. Larger firms may be less susceptible to bankruptcy as they are more diversified as compare to smaller firms which often tries to overcome the costly gap of information when they try to better deal with the lenders of the firms for external financing. As a result smaller firms often less rely on outside sources of financing than firms with big size which have lower information asymmetries, in turn increasing their access to the debt market as the associated cost of debt financing is low in such cases. Moreover, larger firms may have lower variations in earnings which make financial leverage a good option of financing (Hassan, 2010).

The size of a firm plays an important role in determining the kind of relationship the firm enjoys within and outside its operating environment. The larger a firm the greater the influence it has on its stakeholders. Again, the growing influence of conglomerates and multinational corporations in today‟s global economy and in local economies where they operate are indicative of the role firm size plays within the corporate environment. The size of a firm affects its performance in many ways, for this reason, Craig (2015) consider firm size as an important determinant of financial performance.

However, Economics theory prescribes that increasing firm size allows for incremental advantages because the size of the firm enables it to raise the barriers of entry to potential entrants as well as gain leverage on the economies of scale to attain higher profitability (Ali & Ashami, 2016). This implies that the higher the barrier to entry the lower will be the threats of potential competition and the higher the profits that existing firm can earn without inducing entry. Furthermore, literatures of earnings behavior postulated that firm size is an intervening variable in the relationship between the level and variability of return on equity: larger firms tend to have higher levels of profitability and smaller variations in profitability (Alo, 2017).

In addition, Sani and Ali (2017) opine that firm size can be measured using total assets, total sales and number of employees. They denoted firm size by an index which accounted for human capital, economic resources and natural resources available to the firm. They measured firm size as book value to total assets and suggested firm size can be measured using the number of employees or total assets, but most manufacturing firms use natural log of total assets.

Underpinning Theory

Akintoye (2010) identified three essential theories of corporate governance: the steward-ship theory, the agency theory and the market theory. However this study is anchored on the stewardship theory of corporate governance. The stewardship theory of corporate governance holds that, because people can be trusted to act in the public good in general and in the interests of their shareholders in particular, it makes sense to create management and authority structures that, because they provide unified command and facilitate autonomous decision making, enable companies to act (and react) quickly and decisively to market opportunities as it also relates to the asset quality. This approach leads, for instance, to the combination of the roles of the chairman/CEO and for audit committees to ensure compliances to the tenets of corporate governance which invariably affects asset quality of financial institutions. This is because the stock in trade for financial institutions is money that is given out to borrowers as loans, hence the need to adhere in strict terms to the canons of corporate governance to avoid unethical practices in granting and management loan facilities to enable effective performance of loans and the bank's ability to meet up with depositors demand.

Empirical Review

Kajola (2008) in his study on corporate governance and firm performance: the case study of Nigerian listed firms examined the relationship between four corporate governance mechanisms which included BS, BC, CEO status and Audit Committee (AC) to firm performances. Measure ROE and Profit Margin (PM) were used to assess performance of the firm. Samples of 20 Nigerian listed firms from 2000 to 2006 were selected, while panel methodology and Ordinary Least Square method of estimation were used. The results provided evidence of positive significant relationship between ROE and BS as well as Chief Executive Staff. However, the study could not provide a significant relationship between the two performance measures and BC and AC. The data used for the study were derived from audited financial statements of firms listed on the Nigerian stock exchange (NSE). A total of 20 non-financial firms were selected using the combination of non-probability sampling and stratified random sampling techniques.

Equally, Tanko and Kolawole (2010), in their study "Corporate Governance and firms performance in Nigeria, used secondary data based on financial statements of companies from chosen samples, which were randomly selected from companies registered in the stock exchange list. ROE, Net Profit Margin (NPM), Sales Growth (SG), Dividend Yield (DY) and Stock Prices as key variables were used to define the performance of the firm. On the other hand, Corporate Governance was measured based on board independence, board size, and audit independence, ownership of the company and progressive practices of the company. The study found that averages of 30 percent of board members are outsiders which suggest that these boards are relatively not independent. The findings show weak relationship in that direction. The study concludes that the more the outsiders there are on a company's board, the better the performance in terms of Return on equity. The study also recommends the composition of directors to be more of outsiders as there is a relationship between the compositions of directors to the performance of firms. To avoid duality issues, the study suggested that the positions of CEO and the Board Chairman be separated.

Similarly, Samiu and Temitope (2015) in their study Audit Quality (AQ), Corporate Governance and firm characteristics in Nigeria used the population of the study to compose the companies listed on the floor of the Nigerian Stock Exchange. Samples of 58 audited financial reports of quoted companies for the period 2014 were used. The data collected were analyzed using both descriptive and inferential statistics, of which descriptive method described information relating to AC and CEO duality. The study used frequency count, mean, standard deviation, minimum and maximum values variables, while information relating to the composition of outside director, members of the boards, audit committee composition was collected from the companies' annual reports. Results from the study conclude that non-executive directors, ownership, size and leverage significantly have relationship with audit quality.

Several other empirical studies carried out on corporate governance and asset quality with a consensus that corporate governance affects the quality of bank loans or assets. For instance, Akingunola ,Adekunle and Adedipe (2013); Dajoh (2015); Akpan and Riman (2012); Okpanachi (2013); Abata (2014) and Momoh, and Ukpong, (2013) among other studies concludes that corporate governance contributes to the efficient performance of asset quality of the financial sector in both developing and developed economies, but however found that the canons of corporate governance have not been adhered to, in the Nigerian financial sector even after the reforms and recommended that corporate institutions especially the banking sector in Nigeria should adopt the tenets of corporate governance that will attract stakeholders confidence and investment into the industry.

3. Methodology

The research design adopted for this study is the descriptive and inferential research designs. Secondary data were collected from secondary sources from 2006 to 2015. The raw data collected were for BS, BC, AC and FS. The population of the study comprised of all the listed deposit money banks in Nigeria that were in operation in 2006 – 2015. The purpose of choosing this period is to empirically test the significance or the extent to which the corporate governance compliance of the Nigeria banking sector impact on the asset quality of the banking system in the post reform era. This is because the period represents the post 2004 reform period. The data were obtained from the Central Bank of Nigeria (CBN) statistical bulletin, 2015 edition. The study also adopted the check list for corporate governance variable as compiled by Dajoh (2015) for the independent variables. The method of data analysis is the ordinary least square (OLS) multiple regression method with the aid of STATA 13.0 version.

Model Specification

The approach collated data for the corporate governance and asset quality of banking sector in the post consolidation era. In the model, asset quality which is the dependent variable is proxy by loan–to–deposit ratio (LDR). The independent variables are Board size (BS) Board Composition (BC), Firm Size (FS) and Audit Committee (AC). The statistical formulation of the model is therefore presented as follows:

$$LDR = f(BS, BC, FS, AC) \qquad (1)$$

Stochastically the model is presented as thus:

$$LDR = \beta o + \beta o_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \qquad (2)$$

Where:

X_1 = Board Size

X_2 = Board Composition

X_3 = Firm Size

X_4 = Audit Committee

μ = Error term

$\beta 0$ = Intercept

$\beta 1$ = estimation coefficient

Variables measurements

There are two basic variables used in this study. They are corporate governance mechanism (independent) and assets quality (dependent) variables respectively.

Dependent variable and its measurement

The dependent variable used in this study is the assets quality of banks which the researcher proxied by; Loan to deposit ratio (LDR) measured by bank's liquidity by dividing the bank's total **loans** by its total **deposits**.

Independent variable and its measurement

Corporate governance is the independent variable with the following proxies and measurements.

Board size (BS): This is the total number of directors sitting on the board of a particular bank which in line with the code of corporate governance should not be more than 20. This study examines the extent to which bank performance will be affected by the size of the board.

Board composition (BC): This is the number of non-executive directors on the board and it is measured by the percentage of outside directors (non-executive directors) on the total board members.

Audit committee (AC): This is taken as the total number of members in the audit committee. It is expected that the higher the number though within the limit set by code of corporate governance, the better the performance.

Control variable

Firm size (FS) is used as the control variable which is measured by the total value of each bank's assets. Because the values for total assets were too large for the regression analysis, then log of the assets was used to reduce the values. This control variable was introduced because of the notion that performance may also be affected by other factors not captured in the independent variables in which firm size is one.

4. Data Analysis and Discussion

This section provides the most sufficient examination of the result gathered. The study covers a period of ten (10) years. It described the dependent variable and independent variable. It contains the LDR which is the dependent variable. The independent variables include the board size, board composition, audit committee and firm size. The table also described the control variable.

Table 4.1: Summary of Regression Result

Statistics variables	Beta coefficients	t.value	Sig.
FS	-0.4046	-2.04	0.043
BS	-1.5707	-11.11	0.000
BC	0.16221	3.21	0.002
AC	0.68747	3.75	0.000
R^2			0.5408
AdjR^2			0.5281
F.Statistic			42.40
Sign			0.000

Discussion of Findings

The result in table above showed that the explanatory variables accounted for 52.81 of the dependent variable while 47.19 is accounted for by other factors as indicated by the adjusted R-square of 0.5281. The finding reveals that all the variables are correctly signed however BC and AC is positive. The impact of board composition on the asset quality showed that there is a positive and significant relationship between LRD and BC. Also, the impact of audit committee on the asset quality showed that there is a positive and significant relationship between LRD and AC. The implication of this result is that a unit change in BC, AC affects LDR by 0.1622 (16%) and 0.68747 (69%). Also the P-value of 0.002 and 0.000 show that the compliance of deposit money banks to the constitution of boards and audit committee significantly affect the asset or loan quality of the Nigerian banking sector. However the compliance to the board constitution and audit committee is possibly because of the expedition for satisfying different interest groups and not necessarily to ensure an effective and efficient banking sector.

Hypothetically and realistically, it is assumed that corporate governance if complied with should enhance quality and the performance of banks assets quality i.e. bank loans as indicated by their quality of loans. Also, the findings indicate that BS has a t-value of -11.11 and a p-value of 0.000 and a coefficient of-1.5707. This means that BS insignificantly and negatively affects asset quality of deposit money banks for the period under review at 5% level. While the result for FS show that FS had a negative coefficient of -0.4046455 with a p-value of 0.043 which is statistically significant at 5% level which means that FS negatively and significantly affected asset quality. The implication of this result is that corporate governance in the banking sector within the period of under study has been catastrophic resulting to the emergency intervention of the Central Bank of Nigeria (CBN) and the Nigerian Deposit Insurance Corporation (NDIC) in forming the AMCON (Asset Management Corporation of Nigeria) in June 2010.

From the findings, corporate governance in Nigeria has been poor and had a negative effect on the performance of the banks. This is indicated by the negative relationship coefficient of -4.00 and -0.96 respectively implying that as poor corporate governance increases, the performance of the banks falls. The consequence of bad corporate governance is that it reduces the confidence of the public in the financial-banking sector of the economy and thus a fall in savings, bank productivity, profit, fewer investable funds. The robustness of the result is further buttressed by an F-statistic of 42.40. The estimated probability value (prob. F-stat) of 0.0000 is significant enough to conclude that the model has performed well. The coefficient of constant (C) of 82.56898 determine the value asset quality given a unit increase or decrease in any of the explanatory variable while other factors are rendered zero. The overall findings of this study is in line with the empirical evidence of Saniand Ali (2017); Akpan and Riman (2012); Abata (2014); Dajoh (2015); Akingunola, Adekunle and Adedipe (2013); Okpanachi (2013) and Momoh and Ukpong (2013).

5. Conclusion and Recommendations

The findings indicate that corporate governance variables studied insignificantly and negatively affect asset quality except for board size (BS) which indicated a significant and positive effect on the asset quality in the post-reform era. In addition, there is every gain saying that corporate governance in the banking sector are veritable tools for banking sector efficiency if its canons are fully adhered to and the regulatory authorities ensure strict compliance.

Recommendations

The study recommends that:

(1) More efforts should be made to ensure adequate compliance to the reforms and to adhere to corporate governance, as well as it attractiveness and effectiveness in improving performance by banks' boards.

(2) An efficient mechanism should be put in place to improve on the asset quality of Deposit Money banks' to avoid financial distress through unbiased supervision by the regulatory authorities.

(3) Deposit money banks' should ensure strict compliance to the tenets of loans administration and management to avoid incessant bank distress and failures.

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