AN EVALUATION OF THE INFLUENCE OF CORPORATE GOVERNANCE STRUCTURE IN FINANCIAL DECISIONS OF COMMERCIAL BANKS IN NIGERIA.

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ABSTRACT

This study examines the influence of corporate governance structure in financial decisions of commercial banks in Nigeria. Both primary and secondary data were used. 20 commercial banks that operated during 2000-2013 period constitute the sampling frame. In analyzing the data, fixed and random effect models were used. The results show that the coefficient of determination (R^2) indicates that about 61% of change in performance of the banks is accounted for by the explanatory variables while the adjusted R-squared further justifies this effect. From the diagnostics, the fit of the model is good suggesting its appropriateness in evaluating the effects of corporate governance on performance of banks. It is against this background that these recommendations were made that, board members should adhere strictly to commercial banks prudent guidelines. Besides, commercial banks should reduce the number of individuals in their board if they desire to maintain or sustain a good level of performance as well as maintaining a good investment decisions for the overall performance of commercial banking institutions in Nigeria. Also, Portfolio selection and good management (stocks, bonds, treasury bills, mutual funds, etc.) that maximizes the investor's utility should be put in place.

Keywords: Corporate governance structure, Financial Decisions, Performance, Commercial banks, Nigeria.

Introduction

The importance of Commercial banks are very crucial to economic growth of the nation for the services they provide such as financial mediation between savers and investors, credit creation and encouragement of capital accumulation. Essentially, because a bank is funded primarily by depositors, it has an obligation to ensure that the risk which depositors' funds

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are exposed to is minimized through an effective and efficient performance. Thus, performance of the banking industry plays a significant role in determining financial stability of the country (Bhagat and Bolton, 2007; Salazar *et al.*, 2012).

Due to its role as intermediary, performance of commercial banks in Nigeria attracts considerable attention from bank regulators and monetary authorities because of the adverse implications that bank failures have on public confidence in the banking system. The attention from bank regulators was primarily based on poor financial decisions of the banks whose overall performance could lead to erosion of customers' confidence and unhealthy competition.

Prior to the current financial structure in Nigeria, there was lingering distress in the banking industry; the supervisory structures were inadequate, there were cases of official recklessness amongst the managers and the industry was notorious for gross ethical abuses and poor financial decisions. Most especially, poor corporate governance was identified as the major factors responsible for all known instances of bank distress in the country. Poor corporate governance can weaken banks potential and can pave way for financial difficulties (Uwuigbe and Egbide, 2012). Hence, it is therefore pertinent to examines the challenges facing the banking sector following corporate financial scandals, poor corporate governance, ineffective financial decisions and performance of commercial banks in Nigeria.

It is clear that the development of corporate governance in banking requires that one understand how regulation affects the principal's delegation of decision making authority and what effects this has on the behaviour of their delegated agents (Coleman and Nickolas-Biekpe, 2006). They further suggested that regulation has at least four effects on the principle regulation of decision making: the existence of regulation implies the existence of an external force, independent of the market, which affects both the owner and the manager; if the market, in which banking firms act is regulated, one can argue that the regulations aimed at the market implicitly create an external governance force on the firm; the existence of both the regulator and regulations implies that the market forces will discipline both managers and owners in a different way than that in unregulated firms; in order to prevent systemic risk, such as lender of last resort, the current banking regulation means that a second and external party is sharing the banks' risk. From the above, the external forces affecting corporate governance in banks include not only distinctive market forces but also regulation.

Better corporate governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision-making. In expectation of such an improvement, the firm's value may respond instantaneously to news

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indicating better corporate governance. However, quantitative evidence supporting the existence of a link between the quality of corporate governance and firm performance is relatively scanty (Imam, 2006).

Black *et al.* (2003) provide empirical evidence that there is a positive correlation between corporate governance and performance, but they have no explanation about the causal relationship. Wang *et al.* (2007) obtained both negative and positive results for different corporate governance variables and Bank performance in Taiwan. Drobetz, *et al.* (2003) explored the relationship between firm-level corporate governance and firm performance. They suggest that good corporate governance leads to higher firm valuation (performance), hence, investors are willing to pay a premium, and bad corporate governance is punished in terms of valuation discounts.

Literature Review

According to Kyereboah-Coleman (2007), the nature of the firm constitutes a dimension of its governance structure. Therefore , institutional ownership influences the investment decision of the firm.

Syriopoulos and Theotokas (2007) studied a single maritime company and found that corporate governance has a central role to play. Yet, the various inter-relationships between governance and short term and long term financial returns remained an unanswered question.

Similarly, Kajola (2008) in his research examined the relationship between four corporate governance mechanisms which included BS, BC, CEO status and Audit Committee (AC) to firm performances. Performance measure such as ROE and Profit Margin (PM) were used to assess performance of the firm. A sample of 20 Nigerian listed firms from 2000 to 2006 was 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.

Materials and Methods

The study was carried out in Lagos and Abuja, Nigeria. The study areas were chosen because of its precedence, geographical location and most of the banks have their headquarters situated in the study areas. Both primary and secondary data were used. The primary data involves a structured questionnaire, which was distributed among the top officials of the sampled banks. This is due to the framework of corporate governance and financial decisions which rested on the administrative structure of the banks. The instrument was validated

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using cronbach–alpha test. While the secondary data covering 2000 – 2013 was collected from the various issues of the Statement of Accounts and Annual Reports of selected banks, the Central Bank of Nigeria's Statistical Bulletin, and Nigeria Deposit Insurance Corporation's Annual Account. 20 commercial banks that operated during 2000-2013 period constitute the sampling frame.

Model specification

In a situation where the data sets have both time and cross sectional dimension as it is the case in this study, a form of generalized linear model such as random effect is usually employed. More specifically, random effect is more appropriate if the unobserved heterogeneity (within the banks and the varying time period) formulated can be assumed to be uncorrelated with independent variables over time and cross sectional dimension, then random effect specifies that the error term is a group specific random element which although random is constant for that group throughout the time period. But in some circumstances dictated by the data type, the unobserved heterogeneity (within the banks and the varying time period) formulated are to be correlated with independent variables over time and cross sectional dimension. In this case, fixed effect estimation model is specified. For a particular data set, the two situations may arise and the researcher may found the need to test for each specification, using Hausman test, which is better for a particular model. Thus, some empirical literature classifies such model as longitudinal or panel data sets. Heterogeneity across units is central to the issue of analysing panel data. The basic framework of the two forms of regression is:

$$Y_{it} = X_{it}\beta + Z_i\pi + \varepsilon_{it} \qquad (1)$$

Where Y is the dependent variable and X represent set of independent variables which do not include a constant term. The heterogeneity or individual effect is $Z_i\pi$ where Z contains a constant term and a set of individual or group specific variables. For this study, random effect model is found appropriate for three specifications viz: finance decision, liquidity and dividend financial decisions model. These specifications are implicitly highlighted below.

$$FDC_{it} = \alpha_0 + \beta_1 BSZ_{it} + \beta_2 BCSit + \beta_3 CEOit + \varepsilon_{it} \qquad (2)$$

$$LIQ_{it} = \alpha_0 + \beta_1 BSZ_{it} + \beta_2 BCSit + \beta_3 CEOit + \varepsilon_{it} \qquad (3)$$

$$DIV_{it} = \alpha_0 + \alpha_0 + \beta_1 BSZ_{it} + \beta_2 BCSit + \beta_3 CEOit + \varepsilon_{it} \qquad (4)$$

Where

FDC represents finance decision of the bank i at time t measured by debt ratio

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BSZ represents the board size

BCS represents board composition

CEO represents CEO duality

LIQ represents bank liquidity

DIV represents bank dividend

However, fixed effect model is found appropriate for one specification viz: investment decision model. This specification is implicitly highlighted below.

$$INV_{it} = \alpha_0 + \beta_1 BSZ_{it} + \beta_2 BCSit + \beta_3 CEOit + \varepsilon_{it}$$

Where

INV represents investment decision while BSZ, BCS, CEO are as defined above.

The Pair-wise correlation analysis was also used to show the relationship between the financial decision variables and corporate governance structure of the commercial banks.

Results and Discussions

Correlation between the financial decisions and corporate governance variables

In order to understand the underlying relationship between the study variables and the level of significance between them, pair-wise correlation coefficient was used. The results of the pair-wise correlation between financial decisions and corporate governance (Table 1) show that linear and positive association exists between debt ratio and board size ($r = 0.46$). Similarly, correlation between debt ratio and board composition is positive and significant ($r = 0.35$). The result implies that finance decisions of banks were correlated with their corporate governance structure. Results further show a positive but insignificant relationship between debt ratio and chief executive officer status. However, the correlation between debt to equity ratio and board size is negative ($r = -0.33$), implying that inverse relationship or association exist between the two variables. The findings further indicate that governance structure had a possibility of being inversely related to finance decisions. Board size is also negatively associated with dividend decisions of banks ($r = -0.271$). Also, the earnings per share (EPS), another indicator of financial decisions is also related positively and significantly to a corporate governance variable: board size. Further, Liquidity has a positive and significant association with board size ($r = 0.379$).

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Board composition, an important measure of corporate governance is found to be positive and significantly related (r = 0.419) to earning per share of banks. The correlation between board composition and liquidity is high and significant (r = 0.62), implying a high and direct relationship between governance structure and investment decision of banks. It is however important to note that correlation only depicts linear association, it does not imply causal relationship between the correlated variables. Hence, there is need for an inferential analysis as highlighted in the section that follows.

Table 1: Pairwise correlation between the financial decisions and corporate governance variables

	Debt	Debt/equity	Dividend	Earnings	Liquidity	Board size	Board comp.	CEO duality
Debt ratio	1							
Debt to equity	0.4136**	1						
Dividend	0.4641**	0.4425**	1					
Earnings	0.5531**	0.5062**	0.2986*	1				
Liquidity	0.6062**	-0.0818	0.0236	0.4324**	1			
Board size	0.4591**	-0.3379*	-0.2714*	0.6459**	0.3796**	1		
Board composition	0.3529*	0.1075	0.1143	0.4195**	0.6217**	0.2070	1	
CEO duality	0.067	0.4758**	0.1491	0.0256	0.4144**	0.1535	0.2167	1

Source: Data analysis, 2014

* Significant at 10%

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** Significant at 5%

An analysis of corporate governance structure and financial decisions using random and fixed effect estimates

The random and fixed effects estimates to analyze the effects of corporate governance structure in financial decisions are presented in Table 2. Based on the Hausman specification test, the results indicate that random effects estimate is most appropriate for the entire financial decisions model with the exception of investment decision model in which fixed effect model is found to be appropriate. All the diagnostics indicate the goodness of fit.

In the finance decision specification which was measured by debt ratio, high board size is shown to have a negative but significant ($\beta = -1.03$, $p < 0.05$) effect on finance decision of the banks. Similarly, board composition has a negative but significant influence on finance decision of the banks ($\beta = -0.14$, $p < 0.05$). However, CEO status does not exert any significant influence on the finance decision of the banks. On the investment decision modelled on ROI, the influence of governance variables such as board size and composition were found to be positive and significant. The result implies that increased number of board size and its composition had an increasing effect on investment decision of the banks. CEO status was also found to be significantly related to investment decisions of the banks. Further, the result indicates that board size has no significant influence in financial decisions of the banks based on liquidity decisions. However, composition of the board is positive and significantly influenced such decision. This is in line with view of Andres and Vallelado (2008) and Klien (2002). Considering the dividend decisions of the banks, all the corporate governance structure had significant and positive influence on the dividend decision of the banks with the exception of board size which exert a negative influence.

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Table 2: Corporate governance structure and financial decisions

Variables	Random effects estimates			
	Finance decision	Investment	Liquidity	Dividend
Board size	-1.03 (2.42)**	0.52 (3.21)**	0.02 (1.29)	-0.11 (2.32)**
Board composition	-0.14 (4.03)**	0.19 (2.65)**	0.35 (4.25)**	0.09 (2.66)**
CEO duality	0.04 (1.59)	0.43 (2.25)	1.57 (1.07)	0.28 (3.42)**
R^2	0.35	0.29	0.63	0.72
Wald chi2 (3)	48.16**	53.69**	109.54***	85.66**
Hausman = 4.12 (0.6609)	4.12 (0.660)	13.61(0.018)	4.09 (0.6729)	3.12 (0.899)

Source: Data analysis, 2014

** Significant at 5%

Conclusions

The results show that high board size would significantly reduce finance decision of the banks which could affect the overall profit in the long run. Hence, high board size is not a good way to raise the profit of commercial banks in Nigeria. The results provide evidence that larger board size tends to ensure that the management control of the banks is weak. Consequently, such weakness in control generates negative influence on the managers to effectively manage the conflict of interest and personal interest and thus, unable to ensure that the managers and bank administrators strive to work for the overall improvement of the banks.

It is against this background that these recommendations were made that, board members should adhere strictly to commercial banks prudent guidelines. Besides, commercial banks should reduce the number of individuals in their board if they desire to maintain or sustain a good level of performance as well as maintaining a good investment decisions for the overall performance of commercial banking institutions in Nigeria. Also there should be focus on the stock ownership of board members, since it is positively related to both future operating

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performance and to the probability of disciplinary management turnover in poorly performing banks. A unified corporate body saddled with the responsibility of collecting and collating corporate governance related data and constructing the relevant indices to facilitate corporate governance research should be put in place. Finally, bank investments should be put in place since results showed that there is a significant negative impact of equity to Assets ratio on bank performance over the years. The implication is that bank investments are not worth equity capital employed or the regulatory authority set up a high regulatory capital. Consequently, policy instruments should encourage commercial banks to invest optimally, while from regulatory perspective, policy directions should be directed towards optimum regulatory capital.

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