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BOARD DIVERSITY AND FINANCIAL PERFORMANCE OF PRIVATE COMMERCIAL BANKS IN ETHIOPIA

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ABSTRACT

Corporate governance is becoming the agenda of discussion among academicians, financial regulators and government as a result of corporate scandals and malpractices around the world. Corporate governance mechanism can be viewed from both internal and external dimensions. In an economy where the external mechanism is not effective, the internal mechanism related to board, play crucial role in regulating the activities of managers and align interest of management with that of shareholders and other stakeholders. Literatures witnessed that diversity of board, is in its central part to enable board to effectively discharge its responsibilities. The objective of this research therefore, is to analyze the effect of board diversity on financial performance of private commercial banks in Ethiopia. Data for the study was collected from financial statement and documents of six commercial banks for the years 2000 to 2013. An econometric model has been applied to panel data of fourteen years. The analyzed data revealed mixed results. While availability of older directors in the board enhances return on assets, its proportion has reverse effect. Board gender diversity has significant positive effect on net interest margin but significant negative effect on return on equity. Ethnic diversity has positive effect on return on equity but has no effect on other performance measurements in private commercial banks in Ethiopia.

Key Words: Board Diversity, Commercial Banks, Ethiopia, Performance

1. BACKGROUND OF THE STUDY

Board is the important mechanism through which shareholders monitor the actions of management (Ngugi, 2012) & (Kilic, 2015). According to (Campbell & Vera, 2008) in countries where external corporate governance mechanisms are less effective, board's role of monitoring management play significant role for success of firms. Firms' performance on the other hand, is attached to the boards' monitoring effectiveness. Bourez, (2005) cited diversity and independence of boards as the two basic factors affecting board effectiveness. Bourez (2005) further explained that well diversified board contributed more to the financial wellbeing of firms than board composed of homogeneous groups.

According to (Campbell & Vera, 2008), board diversity in current corporate governance literatures is expressed in terms of different dimensions as gender diversity, age diversity, educational diversity, ethnic diversity and experience diversity among others. As (Marimuthu & Kolandaisamy, 2009) expressed, board diversity as the involvement of women and different ethnic groups in higher level management including board of directors. Campbell & Vera, (2008) also witnessed that board gender diversity affects the quality of monitoring role played by the board, which in turn affects performance of firms.

Campbell & Vera (2008) identified economic and social considerations as the two basic arguments for board gender diversity. The authors states that the ethical or social point of view is directed to mere inclusion of females in the board rooms for the formality of treating society in an equitable level. This is best expressed by (Bourez, 2005) as the one that never moved beyond the "Tokenism". While the economic point of view is aimed at enhancing competitiveness of the board by bringing females how have skills and competencies from which firms could be benefited.

Board diversity enhances performance of firms by bringing more independent and qualified directors in to the board room (Kilic, 2015). Increased board diversity is believed to enhance effectiveness of boards by polling diversified skills, talents, knowledge and experiences and outlooks (Boyle & Jane, 2011). Gender diversity boosts board effectiveness in that female directors have better attendance records than male directors (Adams & Ferreira, 2009). Racial and gender diversity boosts reputation and innovation which are the pillars for improved performance of firms (Miller & Triana, 2009). Akpan & Amran, (2014) also posit that boards composed of different age groups add value to corporations because of skill and experience pools. It is also found that old aged board members have superior advantage of having long lasting relations with other firms while, younger directors may know younger entrepreneurs who provide their firm with various resources (Ali, Ng, & Kulik, 2014).

Regardless of the advantage of diversified board advocated by different current corporate governance literatures, board companies including those in the developed countries are not well diversified. As per (Catalyst, 2014) report the percentage of women in stock index companies are Norway is placed at the top with 35.5 % of women in board rooms, 20.8 % and 19.20 % for Canada and U.S. respectively while Ireland and Portugal at the lower pitch with 10.3 % and 7.9 from European countries. Catalyst (2014) report put Australia at the top having 19.20 % of women at board of indexed companies while Hong Kong, India and Japan have 10.2 %, 9.5 %, and 3.1 % respectively. According to Corporate Women Director International (CWDI, 2015) report, women board seats is 20.0 %, 19.20 %, 14.40 %, 9.40 % and 6.4 % for Europe, United States of America, Africa, Asia -Pacific and Latin America respectively.

It seems because of these facts that countries are drafting rules and regulations to enforce their companies to organize their boards from diversified groups particularly of gender mixes. For instance, Israel (1991), Malaysia (2011), India (2013), Germany (2014) issued quota legislatives to incorporate female directors in boards of public listed companies. For instance Israel's legislative require one woman in the board and that of India require minimum of one woman in the board seats (CWDI, 2015). According to the (CWDI, 2015) report, from Africa South Africa (1996) and Kenya (2010), issued quota legislative for women directors in state owned companies.

In case of Ethiopia, there are neither legal requirements about board diversity nor sufficient literatures regarding the effect of board diversity on the performance of corporations in general and the bank industry in particular. Therefore, this study focuses on assessing the effect of board diversity (gender, age and ethnicity) on the financial performance of selected private commercial banks in Ethiopia.

2. STATEMENT OF THE PROBLEM

Following the global financial crisis, corporate governance issue become the agenda of many researchers, giant corporations, leaders and regulators (Ngugi, 2012), (Ujunwa, Okoyeuzu, & Nwakoby, 2012). This is because, the financial crises were caused to happen due to poor governance, accounting and financial reporting malpractices. Good corporate governance resulted in efficient utilization of resource (Ngugi, 2012).

According to (Weir, Laing, & McKnight, 2002), (Tandelilin, Kaaro, Mahadwartha, & Supriyatna, 2007), (Babatunde & Olaniran, 2009), (Damak, 2013) and (Dharmastuti & Wahyudi, 2013) corporate governance mechanisms can be of internal and external. In developing economies like Ethiopia, the internal mechanisms play significant role for regulating the behaviour of management and protecting the interest of shareholders and other stakeholders because of the absence of strong secondary market for corporate control. It is due to these facts that contemporary corporate governance literatures focus on board characteristics and firm financial performance. See (Campbell & Vera, 2008), (Boyle & Jane, 2011), (Yenesew, 2012), (Ashenafi, Kelifa, & Yodit, 2013), (Assefa & Megbaru, 2014). Boards are the basic mechanisms through which owners control the behaviour of management (Ngugi, 2012) & (Kilic, 2015).

For boards to be more effective in regulating and controlling activities within the firm, its diversity is at central point. Diversity; brings more independent and qualified directors in to the board room (Kilic, 2015), polls diversified skills, talents, knowledge, experiences and outlooks (Boyle & Jane, 2011). Racial and gender diversity boosts reputation and innovation which are the pillars for improved performance of firms (Miller & Triana, 2009). Satirenjiit & Shireenjit (2012) & (Garba & Abubakar, 2014) also witnessed that board gender diversity affects firm performance. Age diversity brings skills and experience pools to the board room (Akpan & Amran, 2014).

But most of these researches were conducted in developed nations. Only few focuses on developing economies and even the results of the analysis conducted so far are inconclusive. In Ethiopia, as far as the knowledge of the researchers is concerned, there is scarcity of research conducted to assess the effect of board diversity on performance of companies in general and banking sector in particular. Therefore, conducting such research has an immense importance. Hence, this study is devoted to analyze the effect of board diversity in terms of gender, age and ethnic on financial performance of selected private commercial banks in Ethiopia.

3. OBJECTIVES OF THE STUDY

The main objective of this research is to examine the effect of board diversity on financial performance of selected private commercial banks in Ethiopia.

4. SIGNIFICANCE OF THE STUDY

In Ethiopia, there is scarcity of research regarding board diversity and firm performance in general and the bank industry in particular. Therefore, there is a literature gap that this research would address and belied to fill the gap. This study is very significant in that, it identifies the relationship between board diversity and financial performance of private commercial banks in Ethiopia and suggests bank directors and policy makers to evaluate the appropriateness of the composition of the board in terms of age, gender and ethnicity issues.

5. SCOPE OF THE STUDY

This study is delimited to assess the relationship between board gender, age and ethnicity diversity and financial performance of selected private commercial banks in Ethiopia for the years 2000 to 2013. Other variables were controlled to pinpoint the effect of board diversity on return on assets, return on equity and net interest margin as proxies of performance.

6. REVIEW OF EMPIRICAL LITERATURE

Santirenjit & Shireenjit (2012) found board gender diversity to have positive impact on performance because of the curiosity of females for bell being of their companies compared to males, females are more interested in asking questions and get feedback regarding performance of firms. Wachdi & Mboya (2012) how analysed the effect of bard gender diversity and performance in case of 32 commercial banks in Kenya for the years 1998 to 2009 found negative but insignificant relationship between gender diversity and bank performance. Manini & Abdillahi (2013) found positive relation between gender diversity but concluded that gender diversity has no significant impact on both return on assets and return on equity of banks in Kenya. Garba & Abubakar (2014) found gender diversity to have significant positive impact on return on assets and return on equity but he found no association between gender diversity and Tobin's Q. The authors also asserted that ethnic representation has no significant impact on performance of Insurance companies in Nigeria.

Yenesew (2012) also concluded that board gender diversity no significant effect on the financial performance of the commercial banks in Ethiopia measured by return on assets, return on equity and net interest margin for the years 2007 to 2011. Marimuthu & Kolandaisamy (2009) analyzed the effect of ethnic and gender diversity and found ethnic diversity to have impact on both return on assets and return on equity but no association between gender diversity and return on assets and return on equity for non financial sectors in Malaysia. Adams & Ferreira (2009) also concluded that the greater the gender diversity, the worst the performance of firms become. Campbell & Vera (2008) briefly articulated that female inclusion to the board rooms add value to firms if and only if females come to the board with additional skills and knowledge than satisfying the social pressure of gender equality. Board gender diversity enhances effectiveness of board as female directors have better attendance records than male directors (Adams & Ferreira, 2009).

According to (Catalyst, 2007) report, companies with higher female board members generated 53 %, 42 %, and 66 % return on equity, return on sales and return on invested capital respectively than companies with lower female board members for fortune 500 companies. Regardless of such enormous advantage of board diversity (Bourez, 2005) highlighted that the number of females in the board rooms of countries is still lagging behind.

Regardless of these facts and inconclusive findings by different literatures, (Bourez, 2005) indicated the fact that the diversity of board of companies in terms of women directorship still lag behind. Bourez (2005) further indicated that women occupy only 8 % of the board rooms of top 200 corporations in Europe and surprisingly, 38 % of these companies does not have female directors in their board rooms and 55 % of these companies have only one woman in their board rooms.

Akpan & Amran (2014) who analyzed secondary data of firms listed on Nigerian stock exchange for the periods 2010 to 2012 found insignificant relationship between board composition and firm performance indicating that board members with younger age group lacks sufficient experience and management skills which are important for improving performance of firms . Darmadi (2011) analyzed the relation between board diversity and firm performance in Indonesia and concluded that proportion of younger directors to total directors negatively affect return on assets and Tobin's Q. Darmadi, (2011) further confirmed that gender and ethnic diversity has no significant relationship with return on assets but positive relation with Tobin's Q.

Cedervinge, Montal, & Inwinkl (2014) posit the fact that both aspects of board members composition has its own advantages and disadvantages therefore, having appropriate number is essential. Nakano & Nguyen (2011) assessed the effect of board age diversity on performance and found older directors to be more reluctant in risk taking which negatively affects performance of companies. Akpan & Amran (2014) also found negative relation between younger age and company performance because of lack of experience and managerial skills by younger aged board members. On the other hand (Darmadi, 2011) found that board age diversity has no significant impact on accounting measure of performance of firms.

7. RESEARCH DESIGN AND METHODOLOGY

7.1. METHOD OF DATA COLLECTION AND ANALYSIS

Currently there are sixteen private commercial banks in Ethiopia. From these banks, only six banks satisfy the criteria of having fourteen years financial statements determined as a threshold. The threshold was determined based on the premises of previous literatures that took seven to ten years to conduct similar study. Secondary data was relied on for this particular research. Financial data were collected from the National Bank of Ethiopia and board related information was collected from financial statement, minutes and documents of the respective private banks in Ethiopia for the years 2000 to 2013. Econometric analysis of fixed or random effect model was applied on fourteen years panel data of six private commercial banks using STATA version 11. In order to apply the panel data regression analysis, assumption of the Classical Linear Regression Model (CLRM) was tested.

7.2.DESCRIPTION OF VARIABLES AND MEASUREMENTS

Return on assets expressed as net income divided by total assets, returns on equity ,the ratio of net income to total shareholders' equity and net interest margin, expressed as the ratio of net interest income to earning assets are the proxies of financial Performance. Whereas, the number of female directors in the board room, the number of old age category directors in the board and ethnic diversity; the dummy variable expressed as 1 if the board is ethically well diversified and 0 otherwise are the independent variables for the study. Board size and bank size expressed by natural logarithm of total assets that are identified by previous literatures to have effect on performance of banks are the control variables.

8. MODEL SPECIFICATION

The following model was developed based on prevailing literatures on the effect of board size on financial performance of firms.

$$Y_{it} = \beta + \alpha X_{it} + \varepsilon_{it}$$

Where Y_{it} is the dependent variable (ROA, ROE and NIM) for bank i in year t,

β is the constant term,

α is the vector of coefficient of the independent variables

X_{it} is the vector of the independent variable BGD, BEthD, Bage of bank i for year t, and

ε it is the normal error term.

Therefore, the general empirical research model indicated above was changed into the study variables to see the effect of board diversity on performance of private banks in Ethiopia.

$ROA_{it} = \beta 0 + \beta 1\ (BGD_{it}) + \beta 2\ (BEthD_{it}) + \beta 3\ (Bage_{it}) + \varepsilon_{it}$......(1)

$ROE_{it} = \beta 0 + \beta 1\ (BGD_{it}) + \beta 2\ (BEthD_{it}) + \beta 3\ (Bage_{it}) + \varepsilon_{it}$......(2)

$NIM_{it} = \beta 0 + \beta 1\ (BGD_{it}) + \beta 2\ (BEthD_{it}) + \beta 3\ (Bage_{it}) + \varepsilon_{it}$.........(3)

Where;

i : Denote banks ranging from 1 to 6
t : Denote time in years ranging from 2000 to 2013
ROA*it: Stands for* Return on Asset for bank *i* in year t
ROE*it: Stands for* Return on Equity for bank i in year *t*
NIM*it: Stands for* Net Interest Margin for bank i in year *t*
BGD*it* :*Is* the Number of female board members to total board of bank i in year *t*
BEthD*it: Stands for* Board Ethnic Diversity with dummy variable of 1 if the board is ethnically diversified and 0 otherwise for bank i in year t
Bage*it:* Stands for the number of boards with age of above 60 years of bank i in year *t*

9. TESTS OF CLASSICAL LINEAR REGRESSION MODEL (CLRM) ASSUMPTIONS

The Linear Ordinary Least Square (OLS) model was applied for this research and hence, the linearity of the parameter is assumed. The prevailing literatures were relied on to specify the variables used in the study. Shapiro -Wilk W test, Breusch-Pagan / Cook-Weisberg test, Durbin Watson test, the VIF indicated the validity of the CLRM assumptions except for the first model where minor heteroskedasticity problem has been observed and the robust option has been used to mitigate the problem. Hausman test Breusch-Pagan LM test was made to select between the random and fixed effect model and hence, the random and Fixed effects mode and hence, the OLS and fixed effect model has been used for the second and third model respectively.

10. RESULTS AND DISCUSSIONS

10.1. THE EFFECT OF BOARD DIVERSITY ON PERFORMANCE MEASURED BY RETURN ON ASSETS

This section deals with the effect of board diversity on performance measured by return on assets. The STATA output reveals the effect board diversity with two control variables; logarithm of board size and logarithm of total assets on return on assets.

Where; LogTA; stands for logarithm of total assets, BGD; stands for the board gender diversity expressed by the number of female board members AvFd; stands for the availability of female directors; a dummy variable of 1 if there are female board members and 0 otherwise, Bage; Stands for board age diversity expressed by the number of board members above the age of 60 years, AvOdr; stands for availability of directors with age of 60 years and above a dummy variable of 1 if there are board with age of more greater than 60 years and 0 otherwise, EthD ; stands for ethnic diversity a dummy variable of 1 if the board is ethnically diversified and 0 otherwise and LogBS; stands for logarithm of board size.

Table 1 board diversity and return on assets

Linear regression

Number of obs = 84
F(7, 76) = 6.32
Prob > F = 0.0000
R-squared = 0.2535
Root MSE = .00759

ROA	Coef.	Robust HC3 Std. Err.	t	P>t	[95% Conf	Interval]
LogTA	.004138	.0029142	1.42	0.160	-.0016661	.0099422
Bgd	-.0013044	.002579	-0.51	0.615	-.0064417	.003833
AvFd	.0042383	.004061	1.04	0.300	-.0038514	.012328
Bage	-.003614	.0015039	-2.40	0.019	-.0066102	-.0006196
AvOdr	.014673	.0043024	3.41	0.001	.0061047	.0232426
Ethd	.003134	.0029789	1.05	0.296	-.0027991	.009067
LogBs	.0039283	.0116549	0.34	0.737	-.019284	.0271409
_cons	.0000593	.0140902	0.00	0.997	-.0280038	.0281223

Source: STATA output

As it can be seen on table 1 above, bank size expressed by logarithm of total assets, availability of female directors in the board room, ethnic diversity board size expressed by its natural logarithm have positive effect on performance but none of them are significant. So it can be said that the foregoing variables have no significant effect on performance measured by return on assets. At the same time, the negative effect of board gender diversity is not significant. This is in line with the finding of Yenesew (2012) and (Manini & Abdillahi, 2013).

Table 1 above also clearly shows that the number of older directors has negative effect on performance of banks, which is significant at 5 % significance level. But, the availability of older directors has positive effect on bank performance which is significant at 1 % significance level.

10.2. THE EFFECT OF BOARD DIVERSITY ON PERFORMANCE MEASURED BY RETURN ON EQUITY

Return on equity is the amount of return that banks are generating per a birr of investment made by shareholders. Shareholders are more motivated by the higher return on equity as it gives them a clear figure of the earning bank generated from what has been sowed from their pocket. Table 2 below shows the effect of board diversity on the return on equity of private commercial banks in Ethiopia.

Table 2 the effect of board diversity on return on equity

Source	SS	df	MS		
				Number of obs	= 84
				F(5, 78)	= 21.72
Model	.21299	5	.0425984	Prob > F	= 0.0000
Residual	.152952616	78	.001960931	R-squared	= 0.5820
				Adj R-squared	= 0.5552
Total	.36594461	83	.004408971	Root MSE	= .04428

ROE	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
LogTA	.0814115	.0107751	7.56	0.000	.0599599	.1028631
BS	-.0090469	.0031332	-2.89	0.005	-.0152846	-.0028091
BGD	-.0233515	.0085384	-2.73	0.008	-.0403502	-.0063528
Bage	.0089309	.0070028	1.28	0.206	-.0050106	.0228725
EthD	.0352849	.0133801	2.64	0.010	.0086471	.0619226
_cons	-.0167464	.0477071	-0.35	0.727	-.1117238	.0782311

Source: STATA output

From table 2 above one can see that the two control variables have significant effect on performance of private banks in Ethiopia. Bank six expressed by logarithm of total assets has significant positive effect on performance measured by return on equity implying that bank with larger total assets generate more profit than bank with lesser total assets.

With regard to the effect of board size it is observed that board size has significant negative effect on performance of private commercial banks in Ethiopia which is in line with previous literatures.

The number of female directors in the board room is also observed to have negative effect on return on equity which is significant at 5 % significance level. This is also in line with the finding of (Adams & Ferreira, 2009), (Wachudi & Mboya, 2012) but, against the result obtained by Yenesew (2012), (Manini & Abdillahi, 2013) and (Garba & Abubakar, 2014).

The result of the analysis also revealed that the number of directors above the age of 60 years has no significant effect on return on equity which supplements the finding of (Darmadi,

2011) but contradict the finding of (Akpan & Amran, 2014). But ethnic diversity is observed to have positive effect on return on equity with the implication that the more ethnically diversified board, the better become the financial performance of private banks in Ethiopia.

10.3. THE EFFECT OF BOARD DIVERSITY ON PERFORMANCE MEASURED BY NET INTEREST MARGIN

Banks' basic business activity is mobilizing resource from those who have excess amount in the form of deposit bearing some expenses and channelling them to those with scarcity of these resources earning some interest there by balancing the financial system. This section deals with assessing whether the diversity of board in private banks in Ethiopia affects the net interest margin for the years under consideration.

Table 3 the effect of board diversity on net interest margin

Fixed-effects (within) regression	Number of obs = 84
Group variable: bank	Number of groups = 6
R-sq: within = 0.4284	Obs per group: min = 14
between = 0.0117	avg = 14.0
overall = 0.1974	max = 14
	F(5,73) = 10.94
corr(u_i, Xb) = -0.5140	Prob > F = 0.0000

NIM	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
LogTA	.0077685	.0027305	2.85	0.006	.0023266	.0132104
BS	-.0028349	.0021277	-1.33	0.187	-.0070753	.0014055
BGD	.0049122	.0022401	2.19	0.032	.0004477	.0093766
Bage	-.005068	.0014391	-3.52	0.001	-.007936	-.0021999
EthD	.0023	.0030527	0.75	0.454	-.0037841	.0083841
_cons	.0688461	.0236538	2.91	0.005	.0217041	.1159881
sigma_u	.00853563					
sigma_e	.00895968					
rho	.47577626	(fraction of variance due to u_i)				
F test that all u_i=0:	F(5, 73) = 3.95			Prob > F = 0.0032		

Source: STATA output

The fixed effect model of the board gender diversity on net interest margin shows that bank size in its logarithm of total assets has significant effect on net interest margin. We can clearly observe that regardless of their sign, board size and ethnic diversity have no significant effect on net interest margin.

But board gender diversity is observed to have significant positive effect on performance measured by net interest margin which is significant at 5 % significance level. That is to say that the higher the number of females in the board room, the better the net interest margin become. Similar to its relation with return on assets, the number of board with older age category has negative effect on net interest margin which is significant at 1 % significance level. That is, if the number of directors with older age category increases, the performance of banks measured by net interest margin decreases. Most of the previous literatures fail to see the effect of board diversity in terms of its effect on net interest margin.

CONCLUSION

Similar to most of the previous literatures, this research revealed mixed finding regarding the effect of board diversity on performance. The regression result revealed that, including older directors in the board room up to certain level enhance return on assets of private commercial banks in Ethiopia. But as the number of older director increase, bank performance measured by return on assets and net interest margin tends to decrease. Boards composed of different ethnic groups better perform than board composed of homogeneous ethnic groups which lead to better performance measured by return on equity but it has no significant effect on net interest margin. Finally it can also be concluded that board composed of female directors outperform and resulted in improved net interest margin than board without female directors.

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