

The Effects of Board Size on Financial Performance of Banks: A Study of Listed Banks in Nigeria

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Abstract

A critical review of the Nigerian banking system over the years shows that one of the problems confronting the sector has been that of poor corporate governance. In an attempt to investigate the linkage between corporate governance and financial performance of banks, this study contributed to the existing literature by assessing the effect of size of boards on the performance of banking sector in a developing economy like Nigeria. This study made use of a range of data drawn from the Nigerian Stock Exchange fact book (2008), which contains information on board size and the performance proxies. Regressing performance on board size, it was observed that banks with board size below 13 are more viable than those with board size above 13. The study further observed that banks with larger boards recorded profits lower than those with smaller boards. Therefore, this study concludes that there is a significant negative relationship between board size and bank financial performance with a *t*-value of -1.977 and a *p*-value of 0.053. This is because, increase in board size occurs with increase in agency problems (such as director free-riding) within the board and the board becomes less effective. However, the paper recommends a smaller board size for better financial performance and to reduce the problem of free-rider of banks in Nigeria.

Keywords: Corporate governance, Board Size, Performance, Banking Sector, Nigeria

1. Introduction

The International financial landscape is changing rapidly; economies and financial systems are undergoing traumatic years. Globalization and technology have continuing speed, financial arenas are becoming more open with new products and services being invented and regulators everywhere are scrambling to assess the changes and master the turbulence (Sandeep, Patel, & Lilicare, 2002: 9). An international wave of mergers and acquisitions has swept the banking industry as boundaries between financial sectors and products have blurred dramatically. In this brave new world, one fact remains unchanged. There is the need for countries to have sound resilient banking systems with good corporate governance, which will strengthen and upgrade the institution, to survive in an increasingly open environment (Kaheeru, 2001).

Corporate governance refers to the processes and structures by which the business and affairs of institutions are directed and managed, in order to improve long term share holders' value by enhancing corporate performance and accountability, while taking into account the interest of other stakeholders (Jenkinson & Mayer 1992). Corporate governance is therefore, about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that will foster good corporate performance.

Banking supervision cannot function well if sound corporate governance is not in place, and consequently, banking supervisors have strong interest in ensuring that there is effective corporate governance at every banking organization (Heidi, & Marleen, 2003:4). Changes in bank ownership during the 1990s and early 2000s substantially altered governance of the world's banking organizations. These changes in the corporate governance of banks raised very important policy research questions. The fundamental of such questions is how do these changes affect bank

performance? (Mayes, Halme & Aarno, 2001). It is therefore necessary to point out that the concept of corporate governance has been a priority on the policy agenda in developed market economies for over a decade especially among very large firms. Further to that, the concept is gradually warming itself as a priority in the African continent. Indeed, it is believed that the Asian crisis and the relative poor performance of the corporate sector in Africa have made the issue of corporate governance a catchphrase in the development debate (Berglof and Von-Thadden, 1999).

Several studies have documented the effects of board size as a governance mechanism on the performance of firms. Lipton & Lorsch (1992) and Jensen (1993) suggested that larger boards are less effective than smaller boards due to co-ordination problems in larger boards. They recommended limiting the membership of boards to ten people, with a preferred size of eight or nine. They further opined that even if boards' capacities for monitoring increases with board size, the benefits are outweighed by such costs as slower decision-making, less candid discussions of managerial performance, and bias against risk-taking.

Jensen (1993) took this theme and stated that 'when boards get beyond seven or eight people, they are less likely to function effectively and are not easy for the CEO to control'. Yermack (1996) and Eisenberg, Sundgren, & Martins (1998) provided evidence that smaller boards are associated with higher firm value, as measured by Tobin's Q. Hermalin & Weisbach (2001) argued that board composition is not related to corporate performance and board size is negatively related to corporate performance. On the other hand, Dalton et al. (1999) conducted a meta-analysis of 131 studies and concluded that there exists a non-zero positive relationship between board size and corporate performance. Overall, the impression is that the empirical literature on the relationship between different board characteristics and corporate performance is rather inconclusive. Most of the works have focused on financial firms in general, and industrial firms in particular. Boards of directors in banks and their effectiveness have received only a limited attention and generally there is dearth of studies on corporate governance mechanisms and financial performance of banks in developing countries.

It is against this backdrop that this paper aim to contribute to the existing literature by assessing the effects of size of boards on the financial performance of banking sector in a developing economy like Nigeria.

Apart from the introduction part which constitute section 1 of this paper, this paper is divided into 3 other sections. Section 2 covers the literature review, previous theoretical and empirical studies; section 3 covers the methodology and the result of empirical analysis. Finally, section 4 includes the discussion of findings, conclusion and recommendation.

Hypothesis

H₀: There is no significant relationship between board size and financial performance of banks in Nigeria

H₁: There is a significant relationship between board size and financial performance of banks in Nigeria

Scope of Study

In an attempt to investigate the linkage between board size and financial performance of banks, this study focused on the listed banks in Nigeria. The choice of this sector is based on the fact that the banking sector stability has a large positive externality and banks are the key institutions maintaining the payment system of an economy. The study covers the 21 listed banks in Nigeria as at 2011. The study covers these banks' activities for the post consolidated periods of 3 years (i.e. 2006 to 2008).

2. Literature Review

2.1 What is Corporate Governance?

Corporate governance has been looked at and defined variedly by different scholars and practitioners. However they all have pointed to the same end, hence giving more of a consensus in the definition. For example, Coleman & Biekpe (2005) defined corporate governance as the relationship of the enterprise to shareholders or in the wider sense as the relationship of the enterprise to society as a whole. However, Mayer (1999) also offers a definition and contends that it means the sum of the processes, structures and information used for directing and overseeing the management of an organization. The Organization for Economic Corporation and Development (1999) on the other hand, has defined corporate governance as a system on the basis of which companies are directed and managed. It is upon this system that specifications are given for the division of competencies and responsibilities between the parties included (board of directors, the supervisory board, the management and shareholders) and formulate rules and procedures for adopting decisions on corporate matters.

Similarly, Arun & Turner (2002) contend that there exist narrow approaches to corporate governance, which views the subject as the mechanism through which shareholders are assured that managers will act in their interests. However, Shleifer & Vishny (1997), Vives (2000) and Oman (2001) observed that there is a broader approach

which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be mismanaged and that they earn a return on their investment. There is a consensus, however that the broader view of corporate governance should be adopted in the case of banking institutions because of the peculiar contractual form of banking which demands that corporate governance mechanisms for banks should encapsulate depositors as well as shareholders (Macey & O'Hara (2001).

Arun & Turner (2002) joined the consensus by arguing that the special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to restrain the behaviour of bank management. They further argued that, the unique nature of the banking firm, whether in the developed or developing world, requires that a broad view of corporate governance, which encapsulates both shareholders and depositors, be adopted for banks. They opined that, in particular, the nature of the banking firm is such that regulation is necessary to protect depositors as well as the overall financial system.

This study therefore adopts the broader view and defines corporate governance in the context of banking as the manner in which systems, procedures, processes and practices of a bank are managed so as to allow positive relationships and the exercise of power in the management of assets and resources with an aim of advancing shareholder value and shareholder satisfaction together with improved accountability, resource use and transparent administration.

2.2 Corporate Governance and Banks

Corporate governance is a crucial issue for the management of banks, which can be viewed from two dimensions. One is the transparency in the corporate function, thus protecting the investors' interest (reference to agency problem), while the other is concerned with having a sound risk management system in place (special reference to banks) (Jensen & Meckling, 1976).

The Basel Committee on Banking Supervision (1999) states that from a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:

- i) set corporate objectives (including generating economic returns to owners);
- ii) run the day-to-day operations of the business;
- iii) consider the interest of recognized stakeholders;
- iv) align corporate activities and behaviours with the expectation that banks will operate in safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors.

On a theoretical perspective, corporate governance has been seen as an economic discipline, which examines how to achieve an increase in the effectiveness of certain corporation with the help of organisational arrangements, contracts, regulations and business legislation. It is not a disputed fact that banks are crucial element to any economy; this therefore demands that they have strong and good corporate governance if their positive effects were to be achieved (Basel Committee on Banking Supervision, 2003).

King & Levine (1993) emphasized the importance of corporate governance of banks in developing economies and observed that: firstly, banks have an overwhelmingly dominant position in the financial system of a developing economy and are extremely important engines of economic growth. Secondly, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for majority of firms. Thirdly, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy's savings.

Donald Brash the Governor of the Reserve Bank of New Zealand when addressing the conference for Commonwealth Central Banks on Corporate Governance for the Banking Sector in London, June 2001 observed that:

"... improving corporate governance is an important way to promote financial stability. The effectiveness of a bank's internal governance arrangements has a very substantial effect on the ability of a bank to identify, monitor and control its risks. Although banking crises are caused by many factors, some of which are beyond the control of bank management, almost every bank failure is at least partially the result of mis-management within the bank itself. And mis-management is ultimately a failure of internal governance.

David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, observed in 2000 that:

"Corporate governance is of course not just important for banks. It is something that needs to be addressed in relation to all companies' ... sound corporate governance is particularly important for banks. The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking

systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore is to try to ensure that banks are properly managed."

2.3 State of Corporate Governance in Nigerian Banks

Owing to the unique nature of banking, there are adequate corporate governance laws and regulations in place to promote good corporate governance in Nigeria. Some of the most important ones include: the Nigeria Deposit Insurance Corporation (NDIC) Act of 1988, the Company and Allied Matters Act (CAMA) of 1990, the Prudential Guidelines, the Statement of Accounting Standards (SAS 10), the Banks and Other Financial Institutions (BOFI) Act of 1991, Central Bank of Nigeria (CBN) Act of 1991, CBN Circulars and Guidelines, among others (Adenikinju & Ayorinde, 2001). Also, there are some government agencies and non-governmental associations that are in the vanguard of promoting good corporate governance practices in the Nigerian banking sector. These organizations, apart from the CBN and NDIC, include the Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), Corporate Affairs Commission (CAC), Chartered Institute of Bankers of Nigeria (CIBN), Institute of Chartered Accountants of Nigeria (ICAN), Financial Institutions Training Centre (FITC) among others (Umoh, 2002).

2.4 Prior Studies on Board Size and Financial Performance

It's the duty of Board of directors to ensure that the organization is taking full advantage of the opportunities and that market value of the firm is increasing. A board can be effective if its decision power and influence on the managers is very strong. The effectiveness of the board of directors and effect on performance of the firms has been studied widely (John & Senbet, 1998). Chaganti, Mahajan & Sharma (1985) argued that board size is a significant board attribute and affects board functions and eventually corporate performance. Lipton & Lorsch (1992) and Jensen (1993) asserted that large boards could be less effective than small boards. Increase in board's size, occurs with increase in agency problems (such as director free-riding) within the board and the board becomes less effective. Jensen (1993) also supported the theory of Lorsch (1992) and further added that the decision-making power of the board becomes slower with the involvement of more people.

Yermack, also conducted his study on 452 US firms between 1984 and 1991 and took Tobin's Q as an approximation of market valuation. He documented an inverse association between board size and firm value. He further asserted that the fraction of lost value occurs more when size of firm is increasing from small to medium (for example from 6-12) as compare to the firm whose board size is increasing from medium to big (say 12-24). Eisenberg, Sundgren & Martin (1998) documented a similar pattern for a sample of small and midsize Finnish firms. Their study also revealed that board size and firm value are negatively correlated.

Bennedsen et al (2004) studied the relationship between board size and performance of 500 Danish firms. Their study also supported a negative relationship between the two. However, authors also observed that board size below six has no effect on performance. It's viable for only large size board (more than seven) Diwedi & Jain (2002), conducted a study on 340 large, listed Indian firms for the period 1997- 2001. This study found a weak positive relation between board size and performance of the firm. Adams & Mehran (2005) accessed the relationship between banking firm's performance (represented by Tobin's Q) and board size and found a non-negative relationship between board size and Tobin's Q. They further argued that M&A activity and features of the bank holding company organizational form might make a larger board more desirable for these firms. They further explained that the board size is significantly related to characteristics of the sample firms' structures.

In Ghana, it has been identified that small board sizes enhances the performance of Micro Finance Institutions, Kyereboah-Coleman & Biekpe, (2005). Mak & Yuanto (2003) previously echod the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when board has five directors, a number considered relatively small in those markets. In a Nigerian study, Sanda, Mukaila & Garba, (2003) found that, firm performance is positively related with small, as opposed to large boards. Kajola (2008) also a Nigerian study observed that there is a strong positive relationship between board size and financial performance of listed companies.

3. Methodology

In analyzing the relationship between board size and financial performance of banks in Nigeria, this study made use of secondary data. The study used a range of data drawn from the annual reports of the banks under review and also the Nigerian Stock Exchange Fact Book (2008). This data base contains detailed information on the financial

performance of all listed companies in all segments in Nigeria. It also contains information on ownership pattern and board size which was useful for the analysis in this study. We adopted the regression analysis in analysing the impact of the corporate governance proxy (board size) on the performance of the listed banks. However, the Pearson correlation was also used to measure the degree of association between variables under consideration.

4. Model Specification

Since the two constructs involved in this study are corporate governance (Board size) and Performance (ROE). The regression equation is as computed below:

Equation 1 can be defined as:

$$ROE = f(CG) \quad (1)$$

Therefore representing equation with the variables of the construct, hence the equation therefore becomes;

$$ROE = f(\text{Board Size}) \quad (2)$$

Therefore the Regression Equation is:

$$ROE_{it} = \beta_0 + \beta_1 BOS_{it} + e_{it} \quad (3)$$

Where; ROE_{it} represents firm performance variable which is Return on equity for banking firms at time t.

e_{it} , the error term which account for other possible factors that could influence ROE_{it} that are not captured in the model.

A priori expectation: is such that an increase in board size will lead to an increase in financial performance i.e. $\alpha_1 > 0$

Discussion of Results

Table 1 (see appendix 1) revealed that on the average, the banks included in our sample generates Return on Equity (ROE) of about 5% and a standard deviation of 4.7%. This means that the value of the ROE can deviate from mean to both sides by 4.7%. The maximum and minimum values of ROE are 1% and 22% respectively. From the model, the average board size from the 63 observations is about 13 suggesting that banks in Nigeria have relatively moderate board sizes as suggested by Kyereboah-Coleman and Biekpe (2006) with a maximum board size of nineteen (19) and deviation of 2.48. The implication is that banks in Nigeria have relatively similar board sizes.

From the table 2 result, (see appendix 2) a negative correlation with a coefficient of -0.681 is seen to exist between board size and financial performance (ROE) as it relates to the studied banks in Nigeria. This is seen to be significant at 1%. Also from the regression result (appendix 3), a negative relationship with a t- value of -1.977 and a p- value of 0.053 were recorded. The R- squared result shows that a unit change in BOS will lead to about 66% change in ROE. This is complimented by the Adjusted R Squared of about 63%. The significant value of the F- Statistics further justifies that the model is not bias. On the premise of these results, since the negative effect is significant, we therefore reject the null hypothesis and accept the alternate hypothesis which states that there is a significant relationship between BOS and ROE. This invariably means that the board size must be considered while taking financial decisions. The result therefore supports the agency theory as the large board members being the agents, tend to look after their own interests.

The significant negative relationship found between bigger board size and ROE is consistent with the conclusions drawn by Yermack (1996), Eisenberg, Sundgren and Wells (1998) and Conyon and Peck (1998) and Loderer and Peyer (2002). They have reported a significant negative relationship between board size and the performance of a firm. The result however, differs from Kyereboah-Coleman and Biekpe (2005) who concluded with a positive relationship between a firms' value and board size. The result of the hypothesis also differs from Zahra and Pearce (1989) who argued that a large board size brings more management skills and makes it difficult for the CEO to manipulate the board.

5. Conclusion and Recommendations

We therefore conclude that there is a negative relationship between board size and bank financial performance in Nigeria. Also that larger board are less effective than smaller boards because, increase in board's size occurs with increase in agency problems. Invariably this makes the decision-making power of the board to become slower with the involvement of more people. Furthermore, the paper concludes that a large board size leads to the free rider problem where most of the board members play a passive role in monitoring the firm. Moreover, the board members tend to become involved in dysfunctional conflicts where the board is not cohesive (board members are not working

optimally to achieve a single goal) deteriorating the value of a firm. This view is also shared by Pathan, Skully and Wickramanayake (2007).

Based on this, the paper recommends a smaller board size (6 and 8) for better financial performance of banks in Nigeria. This will reduce the problem of free rider and enhance effective monitoring and decision making. It will also bring about cohesion among the board members.

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Appendix 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROE	63	.01	.22	.0494	.04721
BOS	63	6.00	19.00	13.2381	2.48034
Valid N (listwise)	63				

Source: computed by researcher using data extracted from annual reports of banks (2009)

Appendix 2: Correlation Result

		ROE	BOS
ROE	Pearson Correlation	1	-.681(**)
	Sig. (2-tailed)		.000
	N	63	63
BOS	Pearson Correlation	-.681(**)	1
	Sig. (2-tailed)	.000	
	N	63	63

** Correlation is significant at the 0.01 level (2-tailed).

Source: computed by researcher using spss 15 (2011)

Appendix 3: Regression Result

Independent variables	ROE
BOS	-0.004 [-1.977]* {0.053}
R Squared	0.659
Adjusted R Squared	0.635
F- Statistics	28.009***
Number of Observations	63

Note: t-statistics are shown in the form [], while p-values are in the form { }.

*Significant at 10% level

**Significant at 5% level

***Significant at 1% level

Source: computed by researcher using spss 15 (2011)