# CORPORATE GOVERNANCE AND ASSET QUALITY: EVIDENCE FROM NIGERIAN LISTED DEPOSIT MONEY BANKS (DMBs)

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**Abstract**
*The well-being of any economy is entangled with that of its financial intermediaries. It is for this undeniable reason that regulators continually evaluate and closely monitor the performances of the financial institutions. Series of performance evaluation frameworks are used to check the healthiness of financial institutions but one that has gained global recognition is "CAMELS rating model". Therefore, this study evaluates the enigma between corporate governance indicators and asset quality of DMBs in Nigeria. Using ex-post facto research design, data of 2012 to 2017 were obtained from the annual reports of twelve (12) listed DMBs and analyzed using statistical tools such as simple average, ordinary least square, fixed effect, random effect techniques and decomposition of the selected DMBs. Findings revealed that UBA has the best asset quality with the average ratio of non-performing loan to total loan (0.0175), while Union bank is the least performing bank in terms of asset quality with the average ratio of non-performing loan to total loan (0.2579). The study recommended that CBN should improve on its supervisory responsibilities of the DMBs in Nigeria, especially the ones that were ranked low in order to engender a robust banking sector and sound financial system.*

**Key words:** *asset quality; corporate governance; board size; board independence; bank reform; CAMEL model.*

**JEL Classification:** *G34.*

## I. INTRODUCTION

Corporate governance has become an issue of discussion since its great contributions to the performance of firms (Ehikioya, as cited in Skare & Hasic, 2016). The woeful performance of any business is often traced to absence of a good corporate governance. Banking institutions are critical to the economic development of any nation. In recognition of their important role, central banks in various countries heavily regulate the activities of banks to prevent a systemic collapse and assure financial stability. The wave of financial crisis and corporate scandals between the late 20th century and 21st century has reawakened corporate governance consciousness, leading to several reforms. A set of reforms was introduced in 2004 requiring the consolidation of banks into diversified, reliable and strong capitalized institutions. To achieve this, a minimum capital base of ₦25[1] billion was prescribed for banks, leading to a scramble for mergers and acquisitions and the eventual shrinkage of banks from 89 to 25 by end of 2005 (Soludo, 2006). Currently, the number of listed Deposit Money Banks in Nigeria is twenty-one (21) banks with different licenses of operation ranging from Regional, National and International authorization (CBN, 2018).

One of the factors that determine economic growth is the financial health of banks. According to King and Levine (as cited in Ogbechie & Koufopoulos, 2010), banks play three crucial roles to the development of any nation. Firstly, banks dominate tremendously in the financial systems of developing economies and are very crucial to the growth of an economy. Secondly, in developing economies, majority of firms use these banks as

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[1] ₦ represents Naira which is the Nigerian currency

their main source of finance. Lastly, the main depository for economy's savings and provision of means of payment are banks in developing economies. Therefore, the development of Nigerian economy also lies greatly in the banking sector. In Nigerian financial market, banks have contributed greatly to the sources of finance and bank loans were the largest sources of debt financing in the economy (CBN, 2009).

The banking industry is unique because of the influence of regulation, responsibility to other stakeholders beyond shareholders, capital structure, high-risk, and its complex transactions (Macey & O'Hara, 2003). It therefore becomes imperative to have a board adequately resourced by members with diverse backgrounds, experience, and expertise. However, independent directors are more likely to focus on the aggregate bank performance, while leaving the micro indicators such as asset quality to internal management (Sarkar & Sarkar, 2018).

Corporate governance is credited with the benefits of establishing mechanisms for monitoring, advising, providing strategy formulation and direction for firms. The corporate governance is now expected to reduce the amount of non-performing loan to total loan so as to curb illiquid situations. The issue of deteriorating asset quality continues to plague the Nigerian banking industry, with the ratio of non-performing loan to total loan standing at fourteen percent (14%), and the net carrying value of non-performing loans acquired by the Assets Management Company of Nigeria (AMCON) standing at ₦4.5 trillion as at the end of 2016 (CBN, 2018).

Numerous studies have been conducted on corporate governance mechanisms and financial performance in banking industry at different times in developed, as well as developing countries, most of which are well-documented in accounting and finance literatures (Uadiale 2010; Akpan & Riaman, 2012; Abu, Okpeh & Okpe, 2016). Among these studies, none considered asset quality as one of the elements of CAMELS rating for measuring banks' financial performance alongside corporate governance. It has also been postulated in corporate governance theories that a healthy corporate governance should influence financial performance positively; however, the contrary has been proven (Vintilă & Gherghina, 2012; Jayati & Subrata, 2016). These two issues brought the interest to examine the influence of corporate governance (board independence and board size) on asset quality of Deposit Money Banks in Nigeria.

## II. LITERATURE REVIEW
### II.1. CORPORATE GOVERNANCE AND ASSET QUALITY

Corporate governance has been defined to encompass a set of relationships involving board, management and all stakeholders with a view to attaining a firm's objective (OECD, 2015). Akingunola, Adekunle and Adedipe (2013) defined corporate governance as the way an organization is being run, that is, the application of organization's resources to achieve set goals and objectives. Board size has been widely recognized as one of the vital internal mechanism of corporate governance and contributes greatly to a firm's management. Therefore, the impact of board size on firm's financial performance has been one of the most debated subjects in corporate governance (Isik & Ince, 2016). Asset quality, being one of the indices for measuring performance is described as the classification of credits according to the probability of repayment which estimates the amount of loss that will probably be suffered on deteriorating credits (Abata, 2014). Akingunola, *et al.* (2013) stated that the challenge 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 (Gorowa & Igyo, 2017). Oluyemi (as cited in Gorowa & Igyo, 2017) 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.

### II.2. THEORETICAL FRAMEWORK

Different theories of corporate governance exist in literature, but this study considered three of these theories (stakeholders' theory, stewardship theory and agency theory). However, for this research work, focus is mainly on the stakeholders' theory which states that there is the need for managers to be corporately accountable to all stakeholders, instead of concentrating on shareholders alone. Stakeholders' theory was developed by

Freeman in 1984, he defined stakeholder as any group or individual who can affect or is affected by the achievement of the organization's objectives. An argument was put forward against the narrowness of the agency theory for noting shareholders as the only group interested in corporate entities. Broadening the scope of interested parties, the stakeholder theory stipulates that, a corporate entity is invariably seeking to maintain a balance between the interests of its diverse stakeholders in order to ensure that each interest group receives some degree of satisfaction (Abrams, as cited in Nyarko, Yusheng & Zhu, 2017).

Stewardship theory was brought into management literature by Davis, Schoorman, and Donaldson (1997) as a criticism of the suggested selfishness and shirking of agents. The steward is someone who is responsible to attain a good firm's performance through maximization of shareholders' wealth, thereby maximizing the steward's utility functions. Schillemans and Bjurstrøm (2019) described stewardship theory as a theory which ensures accountability from an executive when a task is delegated by the principal. It is expected that subordinates or executives are encouraged to act in the best interests of their principals, that is, the steward considers organisational goals above his self-interest (Donaldson and Davis, as cited in Schillemans & Bjurstrøm, 2019). Corbetta and Salvato (2004) described stewardship theory as being rooted in a self-actualizing perspective of people. The steward considers self-realization, recognition, achievement, and respect which are the higher need in Maslow's pyramid above self-interest (Davis, Schoorman, & Donaldson, 1997).

Agency theory was propounded by Alchian and Demsetz (1972) and later established by Jensen and Meckling (1976). It is defined as the relationship between the principals and agents. The theory sees shareholders as the principals, while the management who perform the work are the agents. The running of the business is delegated to the directors or managers (agents) by the principals who are the shareholders (Clark, 2004). The introduction of agency theory was to distinguish between ownership and control (Bhimani, 2008). Some of the problems faced by principal-agent relationship is that the agent may yield to self-interest, opportunistic behaviour and neglect of goal congruence between the objectives of the principal and the agent's personal goal. In other words, agency theory concentrates on harmonising the conflicting interest of two self-serving actors. Therefore, agency theory is seen as a theory of conflicting interests (Schillemans 2013).

## II.3. EMPIRICAL REVIEW

Relationship between corporate governance, firms' performance and asset quality have been studied by different researchers and finding have shown a mixed result. Haniffa and Hudaib (2006) investigated the relationship between the structure of corporate governance and performance of 347 companies listed on the Kuala Lumpur Stock Exchange (KLSE) in Malaysia. The study found that board size and shareholding structure were significantly associated with share price and financial performance. Momoh and Ukpong (2013) studied the relationship between corporate governance and organisational profitability in Nigerian Insurance industry. They focused on five companies listed on the Nigerian stock exchange for 2002 to 2011. Their result revealed that corporate governance and insurance industry's financial performance had a significant relationship. Osundina, Olayinka and Ucheagwu (2016) empirically investigated the relationship between corporate governance (measured by Board structure index, ownership structure index and audit Committee index) and firm's performance (measured by return on asset) of selected Nigerian manufacturing companies. They made used of thirty companies for 2010 to 2014. Their results revealed that Board structure index had a significant positive relationship with performance (ROA). Also, it was found that audit committee index had a positive but insignificant relationship with the performance, while ownership structure index had an insignificant negative relationship with performance.

Evidence of corporate governance practices leading to lower non-performing loans was not discovered in the work of Sahu, Maharana, and Chaudhury (2017), while suggesting to look into other contributing factors beyond loans and advances, such as macroeconomic variables and other performance measures. Other studies identified determinants of non-performing loans to include inflation, GDP, lending, and unemployment among others (Carlos & Bonilla 2012; Skarica, 2014); poor risk management practices (Gadise, 2014); and firm characteristics such as firm size (Salas & Saurina, 2002). Sarkar and Sarkar (2018) used net non-performing assets and gross non-performing assets as proxies respectively for asset quality and they found board size to have both a significantly negative and positive effect on asset quality. Similarly, they also discovered CEO tenure having a significantly negative effect on asset quality.

### III. METHODOLOGY AND DATA DESCRIPTION
### III.1. FUNDATION OF ESTIMATED MODEL

The model for evaluating the relationship between corporate governance and asset quality in Nigerian banking sector was stated by making board independent and board size proxies of corporate governance, while ratio of non-performing loan to total loan proxy for asset quality. The model is specified as follows:

$$AQ = \beta_0 + \beta_1 BI_{it} + \beta_2 BS_{it} + \mu_{1it} \tag{1}$$

Where:

Asset quality (AQ) = Net non-performing ratio (NNPL/Total Loan);

Board Size (BS) = Number of directors on the board;

Board Independent (BI) = Number of outside directors to total number of directors.

### III.2. DATA

To investigate the relationship between corporate governance mechanisms and asset quality in the Nigeria banking sector, the study adopted ex-post facto design. It made used of secondary data obtained from the annual reports and accounts of twelve (12) banks listed on the Nigerian stock exchange out of the twenty-one (21) banks. These comprised of nine banks with international authorization and three banks with national authorization for the period of 2012 to 2017. These banks were selected because of availability of data and completeness of usable data set, while 2012 was the starting year of study because it was the year that international financial reporting standard (IFRS) was first adopted. The data collected will be ranked according to the result of the simple average, then the banks are further classified into high asset quality bank and low asset quality banks. Pool fixed and random effect techniques using Panel Regression analysis was adopted to derive the estimates of the parameters from the statistical observation of the standard assumptions.

### IV. EMPIRICAL RESULTS
### IV.1. DESCRIPTIVE STATISTICS

Table 1 showed the ranking of sampled banks using the average of their respective asset quality as measure by the ratio of non-performing loan to total loan. Khatri (2019) suggested that maintaining Non-performing asset (NPA) at minimum level indicates better quality of assets of banks and NPA of a bank should be below 3%.

The results revealed that United Bank for Africa has the best asset quality while Union Bank of Nigeria is least rated in terms of asset quality. Based on this ranking, the banks were then divided into two categories, that is, those banks having NPA below 3% (high asset quality banks) and those banks having NPA of 3% and above (low asset quality banks).

**Table 1. Simple Average and Ranking based on Ratio of Non-Performing Loan to Total Loan**

| Year | Access | Diamond | Fidelity | First | Firstcity | Guaranty | Stanbic | Sterling | Union | UBA | Wema | Zenith |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2017** | 0.0301 | 0.0707 | 0.0346 | 0.1017 | 0.0389 | 0.0476 | 0.0832 | 0.0326 | 0.0885 | 0.0262 | 0.0196 | 0.069 |
| **2016** | 0.0178 | 0.0579 | 0.0344 | 0.1229 | 0.0311 | 0.0521 | 0.0607 | 0.0181 | 0.0581 | 0.027 | 0.0125 | 0.0258 |
| **2015** | 0.0206 | 0.0746 | 0.0359 | 0.0634 | 0.0305 | 0.0208 | 0.0681 | 0.0465 | 0.0629 | 0.0156 | 0.0131 | 0.0193 |
| **2014** | 0.0158 | 0.0379 | 0.0322 | 0.0162 | 0.0249 | 0.0035 | 0.0364 | 0.0261 | 0.0773 | 0.0113 | 0.0201 | 0.016 |
| **2013** | 0.0177 | 0.0355 | 0.0389 | 0.0205 | 0.0263 | 0.0216 | 0.0353 | 0.0215 | 0.5264 | 0.0101 | 0.1966 | 0.0194 |
| **2012** | 0.0597 | 0.0373 | 0.0302 | 0.0201 | 0.0197 | 0.0227 | 0.0451 | 0.0292 | 0.7341 | 0.0146 | 0.1356 | 0.0239 |
| **Total** | 0.1617 | 0.3139 | 0.2062 | 0.3448 | 0.1714 | 0.1683 | 0.3288 | 0.174 | 1.5473 | 0.1048 | 0.3975 | 0.1734 |
| **Average** | **0.0270** | **0.0523** | **0.0344** | **0.0575** | **0.0286** | **0.0281** | **0.0548** | **0.0290** | **0.2579** | **0.0175** | **0.0663** | **0.0289** |
| **Ranking** | **2** | **8** | **7** | **10** | **4** | **3** | **9** | **6** | **12** | **1** | **11** | **5** |

Source: Authors' computation, 2019 using MS Excel

### IV.1.1. HIGH ASSET QUALITY BANKS

Table 2 showed those banks that are doing well based on simple average ranking. The result revealed six banks out of the twelve sampled banks as those banks that are having healthy asset quality, that is, those banks that had relatively low non-performing loan to total loan.

**Table 2. High Asset Quality Banks**

| Bank | Average | Ranking |
|---|---|---|
| United Bank for Africa | 0.0175 | 1 |
| Access Bank Plc | 0.0270 | 2 |
| Guaranty Trust Bank Plc | 0.0281 | 3 |
| First City Monument Bank | 0.0286 | 4 |
| Zenith Bank Plc | 0.0289 | 5 |
| Sterling Bank Plc | 0.0290 | 6 |

Source: Authors' compilation, 2019

### IV.1.2. LOW ASSET QUALITY BANKS

Banks with high ratio of non-performing loan to total loan which is unhealthy for the banking sector are presented on Table 3. Six banks fall in this category of low performance in terms of asset quality.

**Table 3. Low Asset Quality Banks**

| Bank | Average | Ranking |
|---|---|---|
| Fidelity Bank Plc | 0.0344 | 7 |
| Diamond Bank Plc | 0.0523 | 8 |
| Stanbic IBTC Bank | 0.0548 | 9 |
| First Bank of Nigeria | 0.0575 | 10 |
| Wema Bank Plc | 0.0663 | 11 |
| Union Bank of Nigeria | 0.2579 | 12 |

Source: Authors' compilation, 2019

### IV.2. REGRESSION RESULTS

Table 4 presented the regression analysis using three regression techniques. The results revealed that both Board Independent (BI) and Board Size (BS) across the three techniques, have a positive relationship with Asset Quality (AQ) with the coefficient of regression of board independent (0.74) and board size (0.05) under the OLS techniques; the fixed effect techniques revealed board independent (1.54) and board size (0.04) respectively also, while the random effect showed board independent (0.93) and board size (0.01) respectively. This means that across the three techniques adopted, board independent had a strong positive relationship with asset quality at 0.01 level of significance, while board size showed a weak positive relationship with asset quality across. This result supports the findings of Momoh and Ukpong (2013) and also the study of Haniffa and Hudaib (2006).

**Table 4. Result of Corporate Governance on Asset Quality**

| REGRESSOR | | OLS | | FIXED | | RANDOM | |
|---|---|---|---|---|---|---|---|
| | | Coef. | Std.Err | Coef. | Std.Err | Coef. | Std.Err |
| BI | | 0.74 | 0.1840* | 1.54 | 0.3048* | 0.93 | 0.2263* |
| BS | | 0.05 | 0.0035* | 0.04 | 0.0116* | 0.01 | 0.0054* |
| BP (LM) Test | P-Value | 0.002 | | | | | |
| H-Test | | 0.001 | | | | | |

*Note: Breusch and Pagan Lagrangian multiplier and Hausman post estimation test respectively*
*\* Level of significance at 1%; BI= Board Independence; BS= Board Size*
Source: Authors' computation, 2019 using STATA 13

In order to confirm the best technique among OLS, fixed effect and random effect, a post estimation test was conducted using Breusch and Pagan Lagrangian multiplier test which tested OLS against random effect. It was revealed that random effect was better than OLS. This incited the check to determine the better technique between random effect and fixed effect using Hausman test. The results showed that fixed effect was preferred to random effect with p-value at 1% level of significance, therefore, the null hypothesis was rejected.

### IV.2.1. POST – CATEGORISATION RESULT

Table 5 showed the after categorisation result of high asset quality banks. It revealed that board independent and board size have a positive but insignificant influence on the asset quality as depicted on OLS and Random technique results, while the result shown by the fixed effect techniques revealed that board independent and board size have negative/positive, but insignificant effect on asset quality respectively.

Consequently, low asset quality banks' results revealed that at 0.01 level of significance, board independent has a positive relationship across the three techniques while board size corroborated board independent from the result shown by OLS and Fixed effect. However, random effect showed that board size had positive relationship with asset quality, but it is significant at 0.1 level of significance.

#### Table 5. Post-Categorisation Results

| REGRESSOR | OLS | | FIXED | | RANDOM | |
|---|---|---|---|---|---|---|
| | Coef. | Std.Err | Coef. | Std.Err | Coef. | Std.Err |
| **High Asset Quality Banks** | | | | | | |
| BI | 0.23 | 0.0413 | -0.01 | 0.0689 | 0.23 | 0.0413 |
| BS | 0.00 | 0.0009 | 0.00 | 0.0029 | 0.00 | 0.0009 |
| **Low Asset Quality Banks** | | | | | | |
| BI | 1.62 | 0.3871* | 4.38 | 0.3733* | 2.89 | 0.4905* |
| BS | 0.00 | 0.0068* | 0.08 | 0.0116* | 0.19 | 0.0119*** |

\* Level of Significance at 1%

\*\*\* Level of Significance at 10%

Source: Authors' computation, 2019 using STATA 13

### V. CONCLUSION

The purpose of this study was to empirically evaluate the influence of corporate governance on asset quality of listed Deposit Money Banks (DMBs) in Nigeria for 2012 to 2017. For the twelve listed banks sampled, the study showed empirical evidences in support of the relationship between corporate governance and asset quality. The study therefore concluded that there is a significant relationship between corporate governance (in terms of board independent and board size) and asset quality (in terms of ratio non-performing loan to total loan). It was also empirically proven that United Bank of Africa has the best asset quality, while Union Bank of Nigeria has the lowest asset quality in Nigeria. The study recommended that CBN should equip their supervisory and monitoring department on how to detect window dressing of financial position of banks. Furthermore, those banks with unhealthy asset quality should be placed under watch or provide a stringent policy to curb them from giving loans to customers.

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