

CORPORATE GOVERNANCE IN BANKS: THE NIGERIAN EXPERIENCE

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Abstract

Recent failures/collapse of high profit institutions around the world such as Enron, Parmalat, Worldcom, Barings Bank to mention just a few have shown that no company can be too big to fail. A common trend that ran through these monumental failures was poor corporate governance culture, exemplified in poor management, fraud and insider abuse by both management and board members, poor asset and liability management, poor regulations and supervision among others. This paper examines the conceptual framework of corporate governance. Some of the components of corporate governance in general and in the Nigerian banking sector in particular were identified and observed. Secondary sources were basically consulted for the purpose of this work and simple percentages were also used to explain a few of the findings. The study revealed that the boards of directors of a good number of these banks were ineffective and that the internal controls were equally weak as a result of the overriding influence of the chairman/chief executive officers. It was also observed that there were instances of insider abuses such as granting of insider related credits, huge non-performing loans and so on. In addition, lack of transparency and non-disclosure of financial transactions were very rampant in the banking sector in Nigeria according to the study carried out. Recommendations made include total separation of ownership from management, sound internal control system, full disclosure of all financial transactions and strengthening the enforcement mechanism of the regulatory authorities.

Keywords: Governance, Insider Abuses, Transparency, Board of Directors, Ownership, Internal Control, Banking Sector, Management, Board Composition, Board Responsibilities, Non-Disclosure

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Introduction

Corporate governance has ignited heightened interest with the collapse of key companies round the world. The demise of Enron, Author Anderson, Health Smith and others took the entire globe by surprise. All the stakeholders are now very interested in setting standards and enacting laws that address current issues to protect unsuspecting investors. In this regard, the United States Congress enacted the Sarbanes-Oxley Act of 2002 to arrest the issue of corporate governance in that country. The principles of corporate governance as enunciated by the Organization for Economic Cooperation and Development (OECD) was prompted by the need for organizations (public and private) to regard transparency and accountability as sacrosanct in their dealings with all stakeholders in order to achieve the main objectives of the organization. Also on the international scene, a lot of seminars and workshops have been organized to drive home the importance of good corporate governance. The outcomes of each of these seminars have formed the basis for setting world-class standards and international best practices aimed at ensuring the adoption of the basic principles of corporate governance globally. (Sanusi, 2004)

The Basel Committee on Banking Supervision states that “corporate governance involves the manner in which the business and affairs of banks are governed by their board of directors and senior management which affects how they:

- set corporate objectives
- operate the banks’ business on a day-to-day basis
- meet the obligations of accountability to their shareholders and take into account, the interest of other stakeholders
- align corporate objectives and behaviour with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations;
- protect the interest of depositors.

Sanusi (2004) observes that “we have witnessed the collapse of many public corporations as well as private business organizations and the attendant negative implications for economic growth and development. Such perverse consequences tend to become extremely worrisome when one realizes that the banking sector has been the worst hit especially since 1990. From the early 1990’s up to 1996, the financial conditions of many banks and non-bank financial institutions worsened significantly and this compelled the regulatory authorities to take decisive steps to restore public confidence in the financial system. During this period the number of banks classified as distressed increased from 8 to 52 (CBN, 1997). The Central Bank of Nigeria (CBN) revoked 4 licenses (3 in 1994 and 1 in 1995). Also, the CBN took over the management of 17 distressed banks in 1995 while one additional one was taken over in 1996. The Bank, in exercising its powers under Banks and Other Financial Institutions Act 1991, (as amended), announced

the revocation of the banking licenses of 26 banks with effect from 16th January 1998 which was necessitated by their grave financial conditions. This has been the precarious situation of the sector up till July 2004 when the then Central Bank governor came up with the N25 billion recapitalization policy for banks in Nigeria.

Nevertheless, weak corporate governance has continued to rear its ugly head in the Nigerian banking sector. It has once again been pushed from the sidelines to the center stage despite the bank consolidation policy introduced by the apex bank between 2004 and 2005. The recent development in the sector which culminated in the sack of the managing/executive directors of the 8 out of the 9 troubled banks consequent upon the audit/examination of the 24 banks in the country has further confirmed that corporate governance is indeed an important issue to be resolved in the Nigerian banking sector if the latest banking sector reforms would ever produce the desired result.

Issues at stake

The study of corporate governance in banks has attracted numerous scholars as a result of the position occupied by the banking sector in the global economy. The issue of ownership and control of banks which in most cases often leads to a fusion of ownership and management encouraged some of the banks to vest the posts of Chairman and that of the Chief Executive Officer in one person. The composition of the board and their responsibilities is another grey area in corporate governance in banks. Consequently, the board is not usually able to perform its functions as effectively as possible. Generally, the internal control in the banking sector is weak as a result of poor internal governance coupled with the overriding influence of the chairman/chief executive officers as the case may be. This has culminated in a lot of insider abuses such as granting insider related credits, huge non-performing loans and so on.

In some developing countries like Nigeria, there is lack of transparency and non-disclosure of financial transactions of the banks. Anya (2003) observes that lack of transparency has obscured the way many financial and economic activities are conducted and has contributed to the alarming proportion of economic/financial crimes in the financial industry. Trust and fiduciary principles, which was the cornerstone of banking, has been completely jettisoned as banks now engage in all forms of sharp practices. Some of these sharp practices involve the deliberate manipulation or distortion of records to conceal the correct and true statement of affairs. Such distortions therefore, would necessarily result in wrong information being sent to these authorities, which should have been in a position to take adequate necessary measures to prevent further deterioration of the bank's position. The regulatory authorities are thus handicapped by such concealment until the bank hits the irreversible point of total collapse. Thus lack of transparency has been identified as one of the most catastrophic modern societal problems plaguing banks today.

According to the Central Bank of Nigeria (2006). The weaknesses in the corporate governance for banks in Nigeria include among others:

- Disagreement between board and management giving rise to board squabbles
- Ineffective board oversight functions
- Fraudulent and self-serving practices among members of the board, management and staff.
- Overbearing influence of Chairman or MD/CEO, especially in family-controlled banks
- Weak internal controls
- Non-compliance with laid-down internal control and operation procedures
- Poor risk management practices resulting in large quantum of non-performing credits including insider-related credits.
- Abuses in lending, including lending in excess of single obligor limit
- Sit-tight directors, even where such directors fail to make meaningful contributions to the growth and development of the bank.
- Technical incompetence, poor leadership and administrative inability.

Objectives of the study

1. To examine the role of board composition, board responsibilities and ownership and control in the governance of banks.
2. To observe the internal control system in the banking sector and the insider abuses perpetrated by the board/management of banks
3. To determine the extent to which the board/management of banks are transparent and the effect of their non-disclosure of financial transactions to the regulatory authorities.

Conceptual framework and literature review

According to Demb and Neubauer (1992), "Corporate governance is the process by which corporations are made responsive to the rights and wishes of shareholders". Tricker (1994), opines that "corporate governance addresses the issues facing the board of directors, such as the interaction with top management, and the relationship with the owners and other interested parties in the affairs of the company including creditors, debt financiers, analysts, auditors and corporate regulators". Shleifer and Vishny (1997) define corporate governance by stating that 'it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. A similar concept is suggested by Caramanolis-Cotelli (1995) who regards corporate governance as being determined by the equity allocations among insiders (including executives, chief executive officers (CEO's), directors or others individuals (corporate or institutional investors who are affiliated with management) and outside investors. The organizations may be for profit or not-for-profit.

John and Senbet (1998) propose a more comprehensive definition that “corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insider and management such that their interests are protected”. They include as stakeholders, not just share holders, but also debt holders and even non-financial stakeholders such as employees, customers and other interested parties. Sanusi (2002) opines that “corporate governance is about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate governance. It is also about how to build trust and sustain confidence among the various interest groups that make up an organization” Sulaiman (2003) observes that it is the framework for accountable decision-making as well as the structure that turns decisions into actions in organizations. He sees corporate governance as the combination of processes, structures and relationships through which business corporations are directed and controlled.

The Business Round Table (2002) opines that effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure. The relationships of the board and management with stockholders should be characterized by candor; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship and their relationships with government should be characterized by a commitment to compliance. It also requires a proactive, focused state of mind on the part of directors, the CEO and senior management, who all must be committed to business success through maintenance of the highest standards of responsibility and ethics. Good governance is far more than a “check-the-box” list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal setting, effective decision-making and appropriate monitoring of compliance and performance. Through such a vibrant and responsive structure, the CEO, the management team and the board of directors can interact effectively and respond quickly to changing circumstances, within a framework of solid corporate values, to provide enduring value to the stockholders who invest in the enterprise.

Board Composition: The composition of board members is proposed to help reduce the agency problem (Weisbach, 1988; Hermalin and Weisbach, 1991). A positive relationship is expected between firm performance and the proportion of outside directors sitting on the board. Unlike inside directors, outside directors are better able to challenge the CEOs. It is perhaps in recognition of the role of outside directors that in the UK a minimum of three outside directors is required on the board; in the US, the regulation requires

that they constitute at least two-thirds of the boards (Bhagat and Black, 2001).

Empirical evidence has grown but the results are very conflicting. Studies by Weisbach (1988) Mehran (1995) and Pinteris (2002) have produced evidence in support of a positive role for outside directors on firm performance. John and Senbet (1998) in a survey of corporate governance reported that the work of Fosberg (1989) was in support of this positive role. Other works have reported no evidence of a similar relationship between firm performance and the proportion of outside directors on the board (Bhagat and Black, 1999,2000; Hermalin and Welsbach, 1991, Yermack, 1996; and Metrick and Ishii, 2002). In fact Weir and Laing (2001) reported a negative relationship! John and Senbet (1998) stress the role of committee structure as a means of increasing the independence of the board. They refer to the work of Klein (1998) and argue for the need to set up specialized committees on audit, remuneration and appointment. Unlike the preceding argument in support of board structures, Laing and Weir (1999) play down their importance, stressing instead the importance of business experience and entrepreneurship. According to them, firms managed by dynamic CEOs tend to perform better than other categories of firms. On the assumption that foreign firms are managed by more experienced CEOs.

Board Responsibilities: Sanusi (2002) contends that the governance of banks rest with the board of directors for this reason the board should ensure that the bank is run with integrity, complies with all legal requirements and regulatory standard and conduct its business in accordance with high ethical standard. Diplock (2004), opines that effective corporate governance is all about boards performance. The task of governing a corporate entity is the work of board of directors. For a board to function effectively, it should be composed of members who are independent, skilled, knowledgeable, experienced and of diverse perspectives. Chukwudire (2004), opines that Nigeria has had a high profile cases of corporate failure which are traceable to weak and ineffective boards. In some cases, the board appears to have been dormant members of such boards-being satisfied with having business cards that identify them as board members. In a number of cases, the boards become a part of management rather than an active monitor of its performance.

Separation of the Chairman from the Chief Executive Officer:- According to Adedipe (2004) it is an important issue in corporate governance. This was initially adduced as the possible explanation for the extent of abuse of office in the United States of America, where the combination of those offices is prevalent-usually in the President of the organization. But the corporate failures and frauds that occurred in the rest of the world weakened the argument. Indeed, the European common business model of separation of these offices and the two-tier Board that is common in Germany have not insured against poor corporate governance. It then brings the argument down to the individuals concerned. Some have combined both offices effectively and ensured strict observance of the ethics of their professions, while

some others abused the privileges of such executive powers. In his own view, Sanusi (2003), contends that combining the position of the Chief Executive with that of the Chairman of the board, could lead to the problem of moral hazard and thereby threaten financial sector stability.

Internal Controls: Sanusi (2002), contends that the primary responsibility of keeping individual banks sound lies with each bank's owners, managers, and the board of directors. Together, they must establish a framework of internal controls and practices to govern the operations of the bank and ensure that it functions in a safe and sound manner. One basic requirement is that persons who control and manage the business of banking must be men of integrity, above board, trustworthy and must possess appropriate skills and experience. Nnanna (2004) opines that the primary responsibility for maintaining financial sector stability lies largely with the owners, directors, and managers of the financial institutions. They must work together to establish a framework of internal controls and practices to govern the operations of the institutions as well as ensure that the institutions function in a safe and sound manner. The internal control systems must include accounting procedures that adhere to generally accepted standards. Poor internal governance is a serious factor in many instances of banking unsoundness.

Insider Related Credits: According to Oluyemi (2005), "A critical review of the nation's banking system over the years have shown that one of the problems confronting the sector had been that of poor corporate governance. From the closing reports of banks liquidated between 1994 and 2002, there were evidences that clearly established that poor corporate governance led to their failures. A further revelation showed that many owners and directors abused or misused their privileged positions or breached their fiduciary duties by engaging in self serving activities. The abuses included granting of unsecured credit facilities to owners, directors and related

companies which in some cases were in excess of their banks' statutory lending limits in violation of the provisions of the law.

Disclosure and Transparency: Sanusi (2002), posits that disclosure and transparency are key pillars of a corporate governance frame work, because they provide all the stakeholders with the information necessary to judge whether or not their interest are being served. He sees transparency and disclosure as an important adjunct to the supervisory process as they facilitate banking sector market discipline. For transparency to be meaningful, information should be accessible, timely, relevant and qualitative. According to Anameje (2007), transparency and disclosure of information are key attributes of good corporate governance which banks must cultivate with new zeal so as to provide stakeholders with the necessary information to judge whether their interest are being taken care of. Sanusi (2003), opines that lack of transparency undermines the ethics of good corporate governance and the prospect for effective contingency plan for managing systemic distress.

Corporate governance and bank liabilities

Corporate governance is even more fundamental to the financial sector of the Nigerian economy (especially, the banking sub-sector). The nature of the business and the antecedents of the operators of Nigerian banks dictate this. Banking business relies largely on funds provided by depositors and other customers, making equity an insignificant source of trading funds. More specifically, customers of Nigerian banks, in the aggregate, accounted for between 83.75% and 97.82% of banks' business volume (i.e., the balance sheet footing) in the 1990's and early 2000's. The evidence of this is in the percentage of total liabilities of banks that equity represented during that period, as follows:

Table 1

Year	Equity	Other liabilities
1991	3.66%	96.34%
1992	5.08%	94.92%
1993	2.18%	97.82%
1994	2.32%	97.68%
1995	2.37%	97.63%
1996	2.69%	97.31%
1997	5.20%	94.80%
1998	8.87%	91.13%
1999	7.71%	92.29%
2000	7.32%	92.68%
2001	7.16%	92.84%
2002	16.25%	83.75%

Note: Customer's and other interests, aside Shareholders'.

Source: Annual Report & Statement of Accounts of the Central Bank of Nigeria for the respective years.

Theoretical framework

Agency Theory: This theory is of the position that in the presence of information asymmetry, the agent who may be a director or a manager is likely to pursue interests that may hurt the principal or share-holders (Ross, 1973; Fama, 1980). At first the theory was applied to the relationship between managers and equity holders with no explicit recognition of other parties interested in the well-being of the firm. This owner/manager theory views shareholders as the true owner of the firm. Thus, bondholders and other lenders, workers and local authorities have no real say in the actions of the firm even though they have rights to certain flow of income. Workers have the right to be paid wages and local authorities have rights to be paid taxes due hence the residual claimants with respect to both control and income and the shareholders. The owners had imperfect information concerning the opportunities facing managers and could not by looking at outcomes, infer whether or not managers had made the decisions. The imperfection of information necessitated the delegation of responsibilities to managers as managers not only knew this but could take actions that exacerbated the asymmetries of information enhancing managers' discretionary authority (Shleifer and Vishny, 1997).

In analyzing the agency problem, Jensen and Meckling (1976), develop a theory of the ownership structure of a firm. The basis for their analysis is the perspective that a corporation is "a legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without the permission of the other contracting individuals". The particular focus on this model is the contract of an agency relationship between a principal (the external owner of the firm) and an agent (the owner-managers, or entrepreneur). They demonstrate that as the owner's manager's fraction of the equity falls (as more equity is sold to outside investors), the utility maximizing agent has the incentive to appropriate a large amount of the corporations' resources in the form of perquisites and to exert less than full efforts to create value for shareholders.

Stakeholders Theory: The agency theory due to subsequent research efforts has its scope being widened to include not just the equity holders but all other stakeholders, including employees, creditors, government, customers, suppliers etc. This approach which attempts to align the interest of managers and all stakeholders has come to be regarded as the "Stakeholder Theory". Clarkson (1994), states that "the firm" is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services. This view was supported by Blair (1995) who proposes that "the goal of directors and management should be to maximize total wealth creation by the firm". The key to achieving this is to enhance the voice of

participants and provide ownership like incentives to those participants in the firm who contribute or control critical, specialized inputs (firms specific human capital) and to align the interest of these critical shareholders with the interest of outside, passive shareholders.

According to Donaldson and Preston (1995), "stakeholders are identified through the actual potential harms and benefits that they experience or anticipate as a result of the firm's actions or inactions". This theory has been subjected to many investigations. John and Senbet (1998) provide a comprehensive review of corporate governance with a particular focus on the stakeholder theory. Here, the authors note the presence of many parties interested in the well-being of the firm and that these parties often have competing interests in the well-being of the firm. While equity holders might welcome investments in high yielding but risky projects for example, such investment might jeopardize the interest of the debt holders especially when the firm is teetering on the edge of bankruptcy. The review also emphasizes the role of non-market mechanisms, for example, the need to determine an optimal size of the board of directors especially in view of the tendency for board size to exhibit a negative correlation with firm's performance. Other non-market mechanisms reviewed by John and Senbet (1998) include the need to design a committee structure in a way that allows the setting up of specialized committees with different membership on separate critical areas of operations of the firm. Such a structure would allow, for example, productivity-oriented committees and monitoring-oriented ones.

Findings and discussions

The study carried out revealed that the structure and composition of the boards in the Nigerian banking sector leaves much to be desired. Although the provisions of Companies and Allied Matters Act 1990 (CAMA) as amended are complied with by the banks in respect of the number of board members, the calibre of the board members in most cases do not meet the required standard. There are instances where those on the board of some banks are either members of a family or friends and associates of the chairman. These categories of people are not often ready to rock the boat but instead they are prepared to rubberstamp the wishes and desires of the chairman. A case in point is that of a particular bank (now liquidated) whose board members are the chairman, his wife, two of his children and three other directors who are his close associates. The board of some of these banks in addition to being improperly constituted lacked the character and the integrity to run the banks. The boards of some banks were also noted to be ineffective in their oversight functions as they readily ratified management actions even when such actions could be seen to violate the culture of good corporate governance,

According to Sanusi (2002), our recent experience with financial sector crises gives cause for great concern. While political interference complicated the problem of corporate governance in state owned banks, private ownership has not wholly guaranteed good governance as

the ownership structure has, in some cases promoted incentives to operate the banks in unsafe and unsound manner. Before the 2004 Banking Sector Reforms, there were serious fusion of ownership and management in so many Nigerian banks. There were no clear-cut differences between the functions of the Chairman and that of the Managing Director and Chief Executive. In fact some of the banks were parading executive chairman and probably a non-executive managing director which negates the provisions of CAMA (1990) and those of Banks and Other Financial Institutions Act 1991. The executive chairmen were both the head of the board and those of management, a practice alien to the Nigerian corporate system and which encouraged absolute powers. This accounted for the terrible attitude of some of these banks' chairmen and directors which culminated in the demise of their banks

Although the Code of Corporate Governance for Banks Post Consolidation has scrapped the post of executive chairman, recent developments in the Nigerian banking sector has shown that few banks, particularly, the ones that have their managing/executive directors sacked with immediate effect are worse off. Some of the MDs wrecked so much havoc on their banks going by the claims of the regulatory authorities and the Economic and Financial Crimes Commission (EFCC).

According to CBN (2006), there were gross non-compliance with laid-down internal controls and operation procedures. There are instances of poor internal governance which have turned the banks into a state of

unsoundness and ill-health. The accounting procedures were not generally complying strictly with the accepted standard hence there were rooms for frauds and forgeries. When there are too many of these, the affected bank would have lost their capital several times before they know. Donli (2004). There were instances of improper and shoddy preparation of accounting and financial reports culminating in lack of accountability and transparency in most of the banks.

Oluyemi (2005) observed that a critical review of the nation's banking system over the years have shown that one of the problems confronting the sector had been that of poor corporate governance. He concluded that the risk assets of a good number of these banks showed that there are insiders abuses in lending. There are huge amount of non-performing loans before the era of bank consolidation. From the closing reports of banks liquidated between 1994 and 2002, there were evidences that clearly established that insider related lending and huge non-performing loans led to their failure. A further revelation showed that many owners and directors abused or misused their privileged positions or breached their fiduciary duties by engaging in self-serving activities. The abuses included granting of unsecured credit facilities to owners, directors and related companies which in some cases were in excess of their banks' statutory lending limits, in violation of the provisions of the law. The magnitude of insider lending and non-performing loans in some of the failed banks is presented in the table below.

Table 2. Extent of insider loans to selected banks in liquidation

S/N	Bank	Ratio of Insider Loans to Total Loans (%)	Ratio of Non-Performing Loans to Total Loans (%)
1	Financial Merchant Bank	66.9	99.5
2	Kapital Merchant Bank	50.0	96.2
3	Alpha Merchant Bank	55.0	90.0
4	United Commercial Bank	81.0	90.0
5	Republic Bank	64.9	98.0
6	Commercial Trust Bank	55.9	100.0
7	Commerce Bank	52.0	86.9
8	Credite Bank	76.0	98.3
9	Prime Merchant Bank	80.7	100.0
10	Group Merchant Bank	77.6	94.5
11	Nigeria Merchant Bank	99.9	95.9
12	Royal Merchant Bank	69.0	98.0

Source: NDIC Annual Report (Various Years).

Even with the conclusion of the consolidation exercise, banks still engage in insider-related credits. Evidences abound that most of these loans were naked in nature. It was observed that the internal control system of these banks were either not existing or very weak. These porous systems enabled the self-serving directors and top management to take advantage of the situation by granting non-collateralized loans thus enriching themselves through the medium of their other businesses which consequently will not allow the banks to operate in safe and sound manner.

Lack of transparency and non or partial disclosure of financial information to the stakeholders in the banking sector have been the bane of this sector. Material information are concealed from the shareholders and other stakeholders as well as the regulatory authorities. This certainly prevents the stakeholders from knowing whether or not they have the necessary information to judge the interest being pursued by the directors and top management. Even when the information are given, they are not often timely, relevant and quantitative. Non-disclosure of financial information is not helping

prospective investors to distinguish between healthy and unhealthy banks so as to be able to take decisions. On the other hand, the supervisory authorities are often handicapped and cannot take pre-emptive measures to sanitize the system.

Conclusion

The study was carried out to examine the extent to which bad corporate governance could have accounted for the crisis witnessed in the Nigerian banking sector before and after the introduction of the policy of consolidation in the Nigerian banking sector. The author was able to identify some components of corporate governance such as board composition, board responsibilities ownership and control, internal controls, insider related credits, transparency and non-disclosure of transactions The study clearly brought out the extent to which these components can affect governance structures in the banking sector, It analyzed the total risk assets granted by some of these banks as at the time of their liquidation and observed that most of the loans granted were either to their directors and or the shareholders even without adequate security The study further revealed that there were instances of lack of transparency from the management and the board of these banks and that there were either partial or non-disclosure of financial transactions. The recommendations made include total separation of ownership from management, sound internal control system, full disclosure of all financial transactions and strengthening the enforcement mechanism of the regulatory authorities.

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