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# ASSESSING THE EFFECT OF BOARD COMPOSITION ON LIQUIDITY RISK MANAGEMENT OF SELECTED DEPOSIT MONEY BANKS IN NIGERIA

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## ABSTRACT

The primary goal of this study is to provide understanding of the extent to which board composition affect liquidity risk management of banks in Nigeria. The study employed Ex-post-facto research design. Data collected from the annual reports of the banks were analyzed using ordinary least square regression techniques. The study found that board composition had a significant and positive impact on liquidity risk management of Deposit Money Banks in Nigeria. The implication of the findings is that high number of non-executive directors in the Board increases the rate at which liquidity risk is being managed by banks in Nigeria. The study recommends that CBN should ensure that the number of non executive directors in the board of directors is significantly higher than the executive directors because of the significant roles the non executive directors play in organizational risk management strategy.

**Keywords:** Corporate Governance, Liquidity Risk management, Banks, Board Composition

## INTRODUCTION

The business failures and fraudulent financial reporting scandals that affected some of the world-known companies such as Enron, WorldCom, Lehman Brothers, Lever Brothers, Union Dicon Salt, and Cadbury Nigeria among others led to a very turbulent time and resulted in a credibility crisis for the Auditing profession. Auditors' failure to reveal inadequacies in financial records and increase reliability and confidence in the use of financial reports was significant factor among these scandals. The financial scandals caused stock markets to drop sharply, employees to lose their jobs, capital providers to lose their investments, and tax collections to shrink. A common cause for this failure resulted from weak internal control which arises from poor corporate governance of organizations (Lawrence, 2013). The financial scandals have placed a significant doubt on the abilities of financial institutions to manage their liquidity risk. These high profile corporate failures and several cases of corporate mismanagement have intensified the debate on the effectiveness of corporate governance as a tool for improving firm performance (liquidity risk management) and protecting investors (Ogege and Baloupremo, 2014).

Furthermore, considering the public loss of confidence as a result of bank distress which has bedeviled the financial sector in the last decade; and the intensity of competition in the banking sector due to the emergence of large number of new banks, every Deposit Money Banks in Nigeria should ensure that it operates on profit and at the same time meets the financial demands of its depositors by managing liquidity risk adequately. Following the increasing worry about the level of liquidity risk management in the Nigerian banking industry, the SEC in 2003 and the CBN in 2006 came up with policies and codes that will ensure that banks manage their liquidity risk adequately as well as increase the standards of accountability and financial reporting in the banking sector. One of such policies is code of corporate governance.

Sanusi (2002) opined that the issues of corporate governance have become so pervasive in recent years and the lessons learned from experiences of corporate organizations have become major actors in the political economy of many countries. Under the current neo-liberal economic philosophy they are regarded as the engine of growth and development. Based on this premise the performance of financial institutions is interest to both the government and the citizens. Essentially, various measures, models and concept name been developed globally and nationally to ensure that financial institutions not only survive but operate in the best interest of all stakeholders including the government. Dealing with them is so important that promoting corporate governance with its attendant challenges have become relevant and timely. Moreover, it is important to recognize that economic performance of any country is shaped largely by the quality and effectiveness of the nation's corporate governance. Thus, the world over, sound corporate governance has become major concern not only to business enterprises, but also to central banks and governments.

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 and 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 mechanisms is not in place, and consequently, banking supervisors have strong interest in ensuring that there is effective corporate governance mechanism at every banking organization (Heidi and Marleen, 2003 cited in Uwuigbe and Fakile, 2012).

Corporate governance mechanisms such as board composition assure investors in corporations that they will receive adequate returns on their investments (Shleifer and Vishny, 1997) and customers that they will receive their deposits on demand. If these mechanisms did not exist or did not function properly, it will be difficult to manage banks liquidity risk. As a result banks will not be able to meet the demands of their customers and shareholders as at when due. However,

the study will focus on the four major attributes of corporate governance as it was explicitly discussed in CBN code of corporate governance for banks and other financial institution in Nigeria which include board size; board composition; board meetings; board gender. Corporate governance mechanism does not only ensure accountability and credibility in the operations of banks, but also help in ensuring transparency in information disclosure that would ensure that the liquidity risk in the Nigerian banking industry is managed more appropriately.

Banks are expected to ensure that they maintain a sound liquidity in order to guarantee that the needs of its numerous customers are met. Liquidity risk is the risk that a financial firm, though solvent, either does not have enough financial resources to allow it to meet its obligations as they fall due or can obtain such funds only at excessive cost (Gianfranco and Pasquale, 2009; Ikpor and Nancy 2016). Ahmed and Ahmed (2012) argued that when the liquidity risk of a bank is managed more appropriately it will enable a bank to fund increases in assets and meet obligation as they come due, without incurring unacceptable losses. Weak board composition in the Nigeria banking industry will not only affect bank' liquidity risk management but also have an effect on bank's performance. Sanusi (2010:7) posited that:

> The huge surge in capital availability occurred during the time when corporate governance standards at banks were extremely weak. In fact; failure in corporate governance at banks was indeed a principal factor contributing to the financial crisis. Consolidation created bigger banks but failed to overcome the fundamental weaknesses in corporate governance in many of these banks. It was well known in the industry that since consolidation, some banks were engaging in unethical and potentially fraudulent business practices and the scope and depth of these activities were documented in recent CBN examinations. Governance malpractice within banks, unchecked at consolidation, became a way of life in large parts of the sector, enriching a few at the expense of many depositors and investors. Corporate governance in many banks failed because boards ignored these practices for reasons including being misled by executive management, participating themselves in obtaining un-secured loans at the expense of depositors and not having the qualifications to enforce good governance on bank management.

Whether the level of board composition in the Nigerian banking industry has led to remarkable improvement in the liquidity risk management of Deposit Money Banks (DMBs) in Nigeria, is still a matter of debate in academic circle. It is against this back drop that the study seeks to ascertain the extent to which board composition had affected the liquidity risk management of Deposit Money Banks in Nigeria.

## REVIEW OF RELATED LITERATURE

### The Meaning of Corporate Governance

Corporate governance has no single accepted definition; this is often attributed to the huge differences in countries corporate governance codes (Solomon, 2010). The definition varies based on the framework and cultural situation of the country under consideration (Armstrong and Sweeney, 2002). Also, the differences in definition can be as a result of the different viewpoint from the different perspectives of the policy-maker, researcher, practitioner, or theorist (Ikpor, Awa and Ozor 2016; Solomon, 2010). The term "corporate governance deals with the ways in which suppliers of finance corporations assures themselves of getting a return on their investment and is about promoting corporate fairness, transparency and accountability (Shleifer and Vishny, 1997) and establishes how the various participants shareholders and other stakeholders; management; the board of directors interact in determining the direction and performance of corporations. Good governance holds management accountable to boards and boards accountable to the owners and other stakeholders. In the case of banks, significant stakeholders include depositors and the banking supervisor such as the Central Banks (Anonymous, 2003).

Good corporate governance is an effective tool for helping a firm enhance transparency and to attain better financial performance (Rogers, 2008). This is because the corporate governance code acts as an instrument to overcome irregular information, provides checks and balances and protects shareholders' interests. The need for an independent board is evident in mitigating this principal–agent relationship. The creation of a board of directors as part of corporate governance attributes is to monitor the firm's performance, thus, protecting the interest of shareholders. It is therefore anticipated that if the firms adhere to good corporate governance practices via an effective composition of board of directors, the firm's value will increase and shareholders' wealth enhanced accordingly.

**Corporate governance mechanisms**

Corporate governance mechanisms relates to the strategies, procedure and tools that are employed in an organization in order to enhance accountability and transparency in the management of the organization. These instruments are: board size; board composition; frequency of board meetings; board gender; CEO duality, age of board members; board education; board experience among others. However, the study focused on the board composition attributes of corporate governance. Board composition is the proportion of non executive directors in a bank board at the end of each accounting year. Due to the fact that non executive directors are usually independent and free from day to day management of banks, they tend to bring their expertise to bear in influencing financial performance. Board composition does not only ensure accountability and credibility in the operations of banks, but also help in ensuring transparency in information disclosure that would enhance good liquidity risk management in the Nigerian banking industry.

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**Importance of corporate governance**

The importance of corporate governance cannot be overemphasized. Corporate Governance increases transparency in the disclosure of financial statements thereby enhancing opportunity for capital to be raised from the capital and financial markets; corporate governance aid in bank survival through mergers, acquisitions, partnership and risk reduction as a result of assets diversification; corporate governance helps to prevent conflict of interest to arise from the boards, managers and owners of capital by providing proper incentive that will enable them to pursue corporate objectives rather than individual objectives; corporate governance helps in enhancing efficient system of internal control through accountability and transparency; corporate governance helps to secure and manage the investments of shareholders.

**The principles of corporate governance**

The revised OECD principles of corporate governance were endorsed in April 2004. The main area covered by the OECD principles includes;

Rights and Equitable Treatment of Shareholders: - Organization should respect the rights of shareholders and help them to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and encouraging shareholders to participate at general meetings.

Interests of other Stakeholders: - Organization should recognize that they have Legal and other obligations to all legitimate stakeholders, i.e. employees, customers government etc.

Roles and Responsibility of the Board: - The Board members have various ranges of skills and understanding to be able to deal with various business issues and the ability to review and challenge management performance.

Integrity and Ethical Behaviours: - Ethical and responsible decision making is not only important for public relations but it is also a necessary element in risk management and avoidance of lawsuits.

Code of Conduct: - Organizations should develop a code for their Directors and Executives to promote ethical and responsible decision making.

Disclosure and Transparency: - Organizations should clarify and make publicly known the roles and responsibilities of the Board and management, to provide shareholders with a level of accountability. They should also implement procedure to independently verify and safeguard the integrity of the company's financial reporting systems. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear and factual information.

**Liquidity Risk Management**

Liquidity can be defined as the state or condition of a business organization which determines its ability to honour or discharge its maturing obligations. These maturing obligations are composed of current liabilities and long-term debts. Liquidity can also be defined as a measure of the relative amount of asset in cash or which can be quickly converted into cash without any loss in value available to meet short term liabilities.

Risk could be defined in many ways, as the firm value reductions due to changes in some fundamental factors of the business environment (Pyle, 1999) or the uncertainties in the firm value or firm performance, the probabilities of occurrence and non-occurrence (Ikpor et al 2016; Raghavan, 2003). Financial risk is so type of risk associated with financial part which means that possible losses due to financial variables. It could be from the financial market, such as interest rate risk, foreign exchange risk or credit risk, or from the internal business, such as liquidity and capital risk. Financial institutions can face some type of risks: risk that can be eliminated by properly organized business, risk that can be transferred to others using some financial instruments and those that can be managed by the firm (Oldfield and Santomero, 1995). For those that could not be eliminated or transferred, and should be absorbed at the bank level, the bank should manage risk effectively so that it can achieve its financial performance goal (Santomero, 1997).

Liquidity risk can be described as the risk of a funding crisis, such as unexpected event in the form of large charge off, loss of confidence, or a crisis of national proportion like existence crisis (Santomero, 1997). Risk management here centers on liquidity facilities and portfolio structure. Recognizing liquidity risk leads the banks to recognize liquidity itself as an asset, and portfolio design in the face of illiquidity concerns as a challenge. Deposit money banks in Nigeria will be able to meet their responsibilities as at when due without incurring losses that are unacceptable when they manage their liquidity risk very well (Ahmed and Ahmed, 2012). Liquidity risk may also originate from the very nature of banking; macro factors that are exogenous and financing and operating policies that are endogenous. A severe liquidity crisis may cause massive drowning in form of bankruptcies and bank runs leading to a drastic financial crisis (Ahmed and Ahmed, 2012).

**Principles of Liquidity Risk Management**

Njogo (2012) states that in order to manage liquidity risk, the following principles must be observed by financial institutions: A liquidity risk benchmark in light of business objectives, strategic direction and overall risk appetite should be established by a bank; policies, strategies and practices that will maintain adequate bank liquidity risk needs to be developed; there should be a periodic review of bank liquidity risk by management of the bank and the report sent to the board of directors for their consideration on regular basis.

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**Empirical Review**

Adeusi, Akeke, Aribaba and Adebisi (2013) examined the impact of corporate governance on the financial performance of Nigerian banking industry using ten banks in Nigeria between 2005 and 2010. Econometrics model was adopted to convey the relationship between increase in the number of executive directors and board composition with bank performance. The estimation of the developed model found that board composition and increase in the number of executive directors was negatively and significantly related to bank's performance. The study recommended that, for better bank performance in Nigeria, banks should increase board size; and reduced the number of outside directors in order to promote corporate governance and enhance complete reliance of bank's clients on them.

George and Karibo (2014) investigated the impact of corporate governance on the financial performance of quoted companies in Nigeria using thirty three (33) companies in Nigeria between 2010 and 2011. Using content analysis the study observed that banks' financial performance was no different from other companies even when corporate governance practices of Nigerian banks was high. In view of this finding the study recommended that a strict adherence of code of best practices of Security and Exchange Commission in order to enhance corporate performance.

Magnus (2014) empirically investigated the effect of corporate governance on bank's risk and efficiency in Sweden using least square regression analysis. The findings of the study revealed that corporate governance had vague impact on banking risk and efficiency i.e. corporate governance variables does not give much explanations on bank risk or efficiency of the bank. In a nut shell the study unveiled that the composition of the directors' board and the size of the directors' board had a very little effect on bank's risk and efficiency. In order to reduce the influence of risk on bank performance, the study recommended that more effort should be focused on improving the mechanism of corporate governance in banks especially board size and board composition.

Odili, Ikenna and Orikara (2015) examined the effect of corporate governance on the performance of commercial banks in Nigeria. A sample of 10 out of the population of 21 commercial banks in Nigeria was studied and the data collected between 2006 and 2014 were analyzed using the ordinary least square estimation method. The findings of the study revealed that board independence, directors' shareholding and audit committee meetings had positive and significant effects on banking sector's performance while board size showed negative and also significant effect on the performance of the banking sector in Nigeria. The study recommended effective monitoring and implementation of both the internal and external corporate governance code already formulated in other to boost the confidence of the shareholders and improve performance of the banking sector.

**Board Composition and Liquidity Risk Management**

As noted by Fama and Jensen (1983), boards are usually dominated by internal managers, whose performance is perceived to be enhanced if they can take decisions and exert maximum control, however in competitive environments such dominant insiders have less likelihood of surviving due to the lack of separation between decision management and decision control. This presents an argument for the presence of non executive directors to ensure board independence from management by clearly segregating the control and management tasks. Additionally, internal managerial disagreements can be mediated by non executive directors, as well as improving relations between internal management and other stakeholders. Therefore, non executive directors are in better position to carry out the monitoring function than the executive directors. Jensen (1993) states the independence of non executive directors helps in constructive criticism, because they will give their opinions without sycophancy or coercion. In addition, non executive directors will help in reducing information asymmetry between the shareholders and the executive directors. This will reduce the agency problem and hence increase the shareholders wealth. Pfeffer and Salancik (1978); Akhalumeh, Ohiokha and Ohiokha (2011); and Odili, Ikenna and Orikara (2015) observed (based on resource dependency view) that independent directors improve information flow and networking with stakeholders and the community, and in terms of their knowledge by providing the management advices on strategic plans and investments and hence protect the firm resources and reduce uncertainty. On the contrary, Adeusi, Akeke, Aribaba and Adebisi (2013) argued that non executive directors are commonly part-time workers, this will undermine their ability to monitor and advise the board because of the lack of the information that they have, and the lack of information concerning daily activities inhibits non executive directors' ability to apply their function to improve firm performance. Therefore, the insider directors are better to undertake the monitoring function to evaluate the top managers (Baysinger and Butler, 1985). However, Magnus (2014) unveiled that the composition of the directors' board had a very little effect on bank's risk and efficiency. Therefore, from the mixed results, there is no consensus as to whether larger or smaller boards are better. Therefore, this study will investigate the impact of board composition on liquidity risk management of Deposit Money Banks (DMBs) in Nigeria during the period 2006 to 2015.

**Theoretical Framework**

The study is anchored on agency theory and resource dependence theory.

**Agency theory**: Agency theory can be traced to Jensen and Meckling in 1976. Agency is a consensual relationship existing between two parties which one, expressly or impliedly authorizes the agent, to act on behalf of another, the principal (the public) in any dealing with third parties (Eisenhardt, 1989). The Agency theory view directors as the agent of the shareholders and therefore there is a need for them to act in the best interest of the shareholders.

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In this situation, sometimes the agent may not act in the best interest of the shareholders which result in an agency loss situation. The agency theory stress the separation of ownership (principal) and managers (agent) in an organization, therefore it is believed that managers may sometimes pursue opportunistic behaviour which may conflict with the goal of the owners (principals) and therefore destroy the wealth of the shareholders.
Agency theory assumes that both the principal and the agent are motivated by self-interest. This assumption of self-interest dooms Agency theory to inevitable inherent conflicts. Thus, if both parties are motivated by self-interest, agents are likely to pursue self-interested objectives that deviate and even conflict with the goals of the principal. Yet, agents are supposed to act in the sole interest of their principals.

**Resource Dependence Theory:** resource dependence theory as propounded by Pfeffer Jeffrey and Salancik G. R. in 1978 holds that the operational environment of the firm is reflected in its board structure (Pfeffer and Salancik, 1978), which entails that directors are selected according to their ability to facilitate access to required resources. Thus, it should be possible to identify firm dependencies from the board composition. Generally, a board with diverse members with varied links to external resources can be expected to have greater access to such resources, which enhances firm performance and value. Resource dependence theory assume that boards with a high composition of non executive directors, due to the wider expertise and knowledge they can provide, as well as improved networking with the external environment and a generally improved reputation (Haniffa and Hudaib, 2006). Thus NEDs can facilitate access to the political and business contacts, capital and information by enhancing networking with external stakeholders, including customers, governments and other companies (e.g. creditors, suppliers and buyers).
Each of the two theories is useful in considering the efficiency and effectiveness of the monitoring and control functions of corporate governance. Resource dependency theory is intended as complements to, not substitutes for, agency theory. Among the two theories discussed, agency theory is the main theory for the study. According to Habbash (2010), the influence of agency theory has been instrumental in the development of corporate governance standards, principles and codes. Hence, Agency theory is the most appropriate because it provides a better explanation for corporate governance roles.

## METHODOLOGY

Data for this study consists of annual observations on 10 DMBs in Nigeria between 2006 and 2015. The data was obtained from annual reports and financial statement of the banks. Because

the data contains information on cross sectional units observed over time, a panel data estimation technique is adopted. This allows us to perform statistical analysis and apply inference techniques in either the time series or the cross−section dimension. The model takes the form: LRMit = α0 + βit BCit + eit… (1) Where i = 10 cross sections and periods t =2006...2015. LRM*it* is a dependent variable which represents bank liquidity risk management measured by ratio of cash and cash equivalent to total deposits and BC*it* is a vector of the independent variable which represents the ratio of non executive directors to the total number of directors in a bank board in each accounting year.

## DISCUSSION OF RESULT

**Table 1 Board Composition and Liquidity Risk Management**

| Variables | Coefficient | Std. Error | t. statistics | P- value |
|---|---|---|---|---|
| Constant | -1.057 | 0.505 | -2.093 | 0.070 |
| Board Composition | 2.375 | 0.832 | 2.855 | 0.021 |
| R square | 0.505 | | | |
| Adj. R square | 0.443 | | | |
| F Statistics | 8.149 | | | |
| F Sig | 0.021 | | | |
| D Watson | 1.024 | | | |

Source: Author's computation using SPSS 20 Results

Table 1 relates LRM (dependent variable) to BC (independent variable). The estimated regression relationship for LRM model is: LRM = -1.057 + 2.375BC. The equation shows that the independent variable (BC) has significant impact on the LRM. The Durbin Watson statistics shows auto correlation as the value is 1.024. However, since it is closer to 1.45, the serial correlation is not extreme. The coefficient of the independent variable indicates positive impact on the LRM at 5 percent level of significance. The student t-test in the regression shows that board composition has the value of 2.855 which is significant at 5 percent while the adjusted coefficient of determination ($R^2$) offers better explanation of the variations in liquidity risk management, as the value is 44.3 percent. Also, the value of the F-statistics is 8.149 with a p-value of 0.021. The standard error of 0.832 is less than half of the coefficients of the variables

1.1875; this shows that board composition does statistically affect liquidity risk management of Deposit Money Banks (DMBs) in Nigeria over the period 2006-2015. The implication of the findings is that an increase in board composition will cause 2.375% increase in the liquidity risk management of Deposit Money Banks (DMBs) in Nigeria. The finding is further supported by the findings of Akhalumeh, Ohiokha and Ohiokha (2011); and Odili, Ikenna and Orikara (2015).

## CONCLUSION AND RECOMMENDATIONS

The study investigates the impact of board composition on liquidity risk management of Deposit Money Banks (DMBs) in Nigeria. The study employed Ordinary Least Square regression techniques to determine the extent to which board composition influenced liquidity risk management of Deposit Money Banks (DMBs) in Nigeria at 5% level of significance. The study reports a significant and positive influence of board composition on the liquidity risk management of Deposit Money Banks (DMBs) in Nigeria over the period 2006 to 2015. The implication of the findings is that an increase in board composition will cause 2.375% increase in the liquidity risk management of Deposit Money Banks (DMBs) in Nigeria. The study recommended that CBN should ensure that the number of non executive directors in the board of directors is significantly higher.

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