Foreign Directors and Firm Performance: An Empirical Study of Banks in Nigeria

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Abstract

*This study examines the relationship between foreign shareholding in a bank's ownership structure and bank performance, and also the relationship between the proportion of foreign directors on the board of a bank and bank performance. Using the Ordinary Least Squares (OLS) technique in estimating the model parameters, it was discovered that foreign shareholding in a bank's ownership structure is positively related to firms' performance, and also the proportion of foreign directors on the board of a bank is positively related to the performance of a bank. This result show all the variables returning positive relationship, and therefore, in consonance with the apriori expectation. However, the results fail the test of significance; therefore, it was recommended that, Banks in Nigeria should encourage the appointments of more foreign directors on their boards, and more foreign investment should be encouraged in the banking sector of the economy. This can be achieved by relaxing the NIPC Act No. 16 of 1995, which allowed limit to the number of foreign directors on the board of firms in Nigeria. However, since all the independent variables (BDMEM, FORSH and FORDIR) proxied in this study failed their test of significance, considerable caution should be exercised in att*empting policy simulation in this regard.

Key Words: bank performance, foreign directors, ownership structure, board membership, foreign shareholding

1.0 Introduction

According to Gomez-Mejia & Welbourne (1991), foreign direct investment of multinational companies had accelerated tremendously over the past decade, and this had mostly occurred in the economies which are developing at a very fast rate. This increase in foreign direct investment brings along with it a serious need to understand the management of funds of these foreign investors towards organizational performance. Foreign investors are usually severed from the firms they invest in both geographically and culturally, and in most cases, their investments and funds are channeled through finance houses which are managed by local managers. There is no substantial reason to expect the local fund managers to behave any differently from other domestic fund mangers, who are known to have a potential for self-interested strategizing, and selfish management behaviour. According to Easterby-Smith, Malina & Lu (1995), much unlike the developed economies of the world, many developing economies like Nigeria are characterized by a chain of corporations owned and governed by family members, and a very high level of government participation, even in the private sector. Since these characteristics are not dominant in developed economies, by observing and studying developing economies in-depth, it would be possible to examine ways in which foreign investors monitor the actions and performance of the management of a firm. The influence of foreign investor groups has been coming under increasingly intense scrutiny, especially in developing countries that have just begun to experiment with open markets.

It has been reported that in firms where there was a substantial foreign interest, foreign investors have sought to exercise their control through foreign directors. The presence of foreign directors on the board of an organization tends to change the ownership-control equation. It enables foreign investors to have a substantial and direct representation that can be employed to influence, and in other instances, dictate how the firm should be governed. This in turn alters, or tilts the direction of the firm in favour of the foreign investors. This places a great importance on the impact of foreign directors in firms located in developing economies on their performance (Carey, 1994). The board of directors as a vital part of a firm's corporate governance system may have foreign directors on the board. The board is saddled with two functions, firstly was to hire, fire, and motivate managers, and secondly, was to advise managers on important strategic decisions. These board responsibilities have important implications on the firm performance (Adams & Forreira, 2009) and it was suggested that a board's effectiveness was determined by how well it can perform these functions in conjunctions. Sakar & Sakar (2000) posits that a study of foreign shareholders in developing economies prove that as the level of foreign shareholding increases, the value of firm (bank) increases fourfold. Likewise, Berger (2005) opines that foreign-owned banks have higher loan quality and lower default risk than state-owned banks. This also accounts for the higher performance of foreign-owned banks in developing economies. This is in line with Yudaeva, Kozlov, Malentieva & Ponomareva (2003) who opine that foreign ownership is more productive than any other bank ownership. A study on the effects of foreign directors on performance and firm performance, Masulis, Wang & Xie (2012) found out that firms with foreign directors make better cross-border acquisitions when the targets are from the home regions of the foreign investors. However, they concluded that where the foreign directors' business presence becomes less important to them, the firm will exhibit poorer performance.

With respect to foreign directors and bank performance, Weisbach (1998) found a positive relationship between bank performance and the proportion of foreign directors on the board. However, Raheju (2005) opine that foreign directors can be constituted to maximize shareholders' value but this depends on the correlation with their presence on boards of banks. This means that Raheju (2005) is not too sure of his submission and he went further to say that it appears the presence of foreign directors on the board of a bank might improve firm performance. Some findings of above these studies are consistent with one another, while others are inconsistent. The point is that, the results are mixed which makes the issue inconclusive. Against the above background, the general objective of this study is to examine (1) the relationship between foreign shareholding in a bank's ownership structure and bank performance, and (2) the relationship between the proportion of foreign directors on the board of a bank and bank performance. The remainder of the paper is organized as follows. First, Section 2 review prior research that has examined the relationship between foreign shareholding and bank performance on one hand, and relationship between the proportion of foreign directors on the board of a bank and bank performance on the other hand. Next Section 3 describes the research methods and model specification followed by Section 4, which presents the results of data analysis by way of the Ordinary Least Square (OLS) technique and finally, Section 5 provides some discussions of findings, conclusions and offers some recommendations based on the findings in the study.

2.0 Literature

Developing economies are embracing globalization at a very fast pace. This can be seen because there has been a significant increase in the number of foreign investors who see opportunities to invest in these economies. These developing countries in turn now see foreign capital as an important factor to fostering socio-economic development (Kang & Sorensen, 1999). This growth brings along with it a serious need to grasp the roles of these foreign investors play in monitoring the actions and performance of the management of firms in which they have invested. According to Montgomery (1994), the foreign investors present in these developing economies are majorly responsible for the presence of foreign directors on board of firms. These, they use to check the self-strategizing tendencies of managers. Several studies have suggested that managers would like to increase their pay package by engaging in unrelated diversification. These selfish motives may take place of, or supersede organizational interests (Lane, Cannela, & Lubatkin, 1998). Since foreign shareholders are not rewarded for such actions, they employ their power to influence the foreign directors present on the board to act as a restraining force against such self-interested strategizing behaviour (Amihud & Lev, 1981).

Managers in firms have the tendencies to use their offices to engage in activities that could helm them to actualize their needs for power and prestige by making decisions that increase the size of the organization. They engage in such activities because they are in better position to have in-depth knowledge of their operational environment and first hand information about critical strategy issues (Baumol, 1959, Williamson, 1964). This may lead to information breakdown between the managers who are involved in organizational affairs on a daily basis and the owners who are less intensely involved (Jensen & Meckling, 1976). Foreign investors could therefore monitor these managers with different mechanisms. Among these mechanisms is the foreign directors present on the boards.

2.1 Ownership Structure and Bank Performance

Ownership structure is measured by the identity and share of the largest owner. Within a country's banking system, ownership is an important factor in the "banking environment" that has a bearing on the design and effectiveness of the regulation and supervision of banks, specifically, banks may be government-owned, domestically-owned, and foreign-owned (Zeitun & Tian, 2007). Brownbridge (2005) defined domestic (indigenous) banks as banks having local investors as the major shareholders, while, Anyanwaokoro (2001) defines domestic banks as banks initiated and fully owned (100 per cent) by indigenes. Classens (1998) considers a bank to be foreign-owned if more than 50 per cent of its capital is owned by foreign residents. To Crystal & Goldberg (2000), a bank is foreign if foreign shareholders own a majority of voting shares or exercise effective management control. It is now well understood that ownership structures vary with important implications for corporate governance and firm performance. In a research study conducted by Crystal *et. al.* (2000), foreign-owned banks, it was discovered, on the whole, tended to be "healthier" than their domestic counterparts. It is a general and overall consensus that banks' cost efficiency and performance is positively associated with foreign ownership. Bonin & Watchel (2005) reports that the participation of foreign investors adds considerably to banks' cost efficiency and ultimately its performance.

2.2 Foreign Ownership and Bank Performance

The evidence of foreign ownership of banks reveals that foreign banks outperform their domestic counterparts in terms of profitability and cost efficiency in developing countries (Bonin & Watchel, 2005). According to Pasiouras & Kosmidou (2007), the best performing banks are those who maintain a high level of equity to their assets. They also opine that overhead costs are an important factor in determining banks' profitability – the higher the overhead cost in relation to the assets, the lower the profitability of the bank and vice-versa. Foreign-owned banks are known to monitor their managers' efficiency and so they would choose the lower cost, or higher profit technology. Banks with significant foreign shareholdings are more technically efficient due to especially to the fact that they operate strictly as profit maximizers. In addition, foreign banks benefit from the advantages of having access to more advanced information technologies and better expertise in the field than their domestic counterparts. They import more effective supervision and regulation practices and enhance competition. They are also less vulnerable to political pressures and less inclined to lend funds to connected parties. According to Bonin et. al. (2005), the participation of international investors adds considerably to bank's cost efficiency. According to Galia & Masulis (1976), foreign-owned banks are motivated to take more risks, and this in turn brings them a higher return as in opposition to state-owned banks. Foreign-owned banks are more efficient than their state-owned counterparts because their performance is not hindered by agency costs, which is dominant in state-owned banks. This agency cost in state-owned banks lead to weak managerial incentives and misallocation of resources. Managers of foreign-owned banks exert much effort in maximizing firm value and do not divert resources for personnel benefits.

Sakar & Sakar (2000) posits that a study of foreign shareholders in developing economies prove that as the level of foreign shareholding increases, the value of firm (bank) increases fourfold. This is responsible for the difference in ROA between foreign-owned banks and domestic-banks. On the average, foreign banks in a developing economy have an ROA of 0.31 points higher than their domestic counterparts. Berger (2005) opines that foreign-owned banks have higher loan quality and lower default risk than state-owned banks. This also accounts for the higher performance of foreign-owned banks in developing economies. This is in line with Yudaeva, Kozlov, Malentieva & Ponomareva (2003) who opine that foreign ownership is more productive than any other bank ownership. These findings confirm the view that foreign-owned banks tends to be more profitable than their domestic counterparts in developing economics (Vander, 1996). It is also a well-known fact that these foreign investors would like to hire foreign directors to monitor managers of these banks of interest. A study on the effects of foreign directors on performance and firm performance, Masulis, Wang & Xie (2012) found out that firms with foreign directors make better cross-border acquisitions whenthe targets are from the home regions of the foreign investors. However, they concluded that where the foreign directors' business presence becomes less important to them, the firm will exhibit poorer performance. In a study on the moderating effect of board diversity on the relationship between board of directors characteristics and firm performance, Al-Matari, Bt-Fadzil & Al-Swidi (2014) found out that the board of directors characteristics and the firmperformance are the moderating effect of board diversity. In addition, they found foreign members of the board to be insignificant in moderating the relationship between board director's characteristics.

2.3 Foreign Directors and Bank Performance

According to Weisbach (1998), there is a positive relationship between bank performance and the proportion of foreign directors on the board. A board with a higher proportion of foreign directors is more effective in monitoring and the executive management, and thereby reduces agency costs. Foreign directors also significantly improve bank performance when their cost of acquiring information is low. A recent CBN/NDIC collaborative study of the performance of the financial sector of the economy, found out that some factors that contributed to the poor performance of banks in Nigeria, amongst others, were bad management, lack of adequate supervision, bad credit policy, and undue interference from board members. The study further showed that a lack of adequate supervision accounted for 22.3% of the causes of bank underperformance (CBN/NDIC, 1995). According to Raheju (2005), fereign directors can be constituted to maximize shareholders' value – the optimization view. Based on this, foreign directors will put the office into good use as monitors and advisers of managers so as to maximize shareholder value. This is so because foreign directors have interests closely designed with shareholders'. This may have a positive correlation on the presence on boards of banks. Given the evidence on the monitoring efficiencies of foreign directors, it appears that at a minimum, their presence on the board of a bank will improve firm performance.

3.0 Methodology

This study is based on a cross-sectional survey of sampled banks for the 2008 financial year. The population is all the commercial banks in Nigeria. This represents the 24 listed banks quoted on the Nigerian Stock Exchange (NSE) as at 31st December, 2008. The year 2008 is used in this study, because data for years 2009 to date are mixed and incomplete, due to the recent crisis in the Nigerian banking sector resulting in merging and re-branding of most of the banks. The sample size is 14 banks, which can be adjudged as representative of the population. The sources of data collected for this study was basically secondary, that is, the annual reports of the sampled banks. The Ordinary Least Squares (OLS) technique was used in estimating the model parameters so as to facilitate the testing of the research hypotheses.

3.1 Model specification

The model for this study is:

ROA = F (BDMEM, FORSH, FORDIR)……………………………………1

Where: ROA = Returns on Assets
BDMEM = Number of board members
FORSH = Percentage of foreign shareholding
FORDIR= Number of foreign directors

Consequently, the econometric model was stated as follows:

$ROA = \beta_0 + \beta_1\ BDMEM + \beta_2\ FORSH + \beta_3\ FORDIR + \mu_t$…………………..2

Where μt = stochastic error term

Apriori expectations, $\beta_{1,}\ \beta_{2,}$ and $\beta_3 > 0$

4.0 Data Analysis and Result

Following from all the explanations made above, the bank performance coefficients of the regression equation as determined by number of Board Members (BDMEM), Percentage of Foreign Shareholding (FORSH) and number of Foreign Directors (FORDIR) are represented in the table below.

Independent Variable	Coefficient	Standard Error	T-Ratio	Prob.
Constant	-25.233	10.2606	-2.4583	.026
BDMEM	1.7167	0.72207	2.3775	.030
FORSH	2.5140	7.0991	.35413	.728
FORDIR	-2.7596	7.2277	-.38181	.708

Source: Result On Computer Estimate of OLS

R-Squared = .28605
R-Bar-Squared = .1521
F-Stat. = F (3, 16) 2.137
DW-Statistic = 1.8
ROA = -25.23 + 1.72 BDMEM + 2.51 FORSH + 7.23 FORDIR
(-2.46) (2.38) (0.35) (-0.38)

The above result was generated by cross-sectional data analysis concerning the bank performance, BDMEM, FORSH, and FORDIR. A close examination of the ordinary least squares regression results indicate that the coefficient of determination (R-square) stood at 0.29 indicating that 29% of the systematic variations in banks' performance is explained by the variations in the control variables. However, the adjusted R-square stood at 0.15 which is also quite low. The F-statistic of 2.137 as a measure of the overall goodness of fit is less than the critical $F_{0.05}$ value of 3.33. This implies that considerable caution must be exercised with regards to the model's predictive capacity and the accuracy of the functional firm of the model. The t-ratio analysis indicative of the individual statistical significance of the explanatory variables shows that the following explains that the variable BDMEM is significant at 5% level and is positively related to firms' performance. This implies that having more persons as members of the board would impact positively on the firm's performance. The result is consistent with the apriori expectations. Consequently, a unit change in BDMEM will result in a positive effect on firm performance by 1.72 units. The conclusion is that we fail to reject the alternative hypothesis which indicates a positive relationship between number of directors on the board and bank performance.

Likewise, the results reveal that FORSH is positively related to firms' performance. This is in consonance with the apriori expectation. The outcome is also in consonance with previous empirical studies (Vander, 1996). The implication therefore is that an increase in the proportion of foreign shareholding is likely to influence bank performance positively. Specifically, the results indicate that a unit change in the percentage of foreign shareholding will result in a change in banks' performance by 2.51 units. However, the result fails the test of significance given that its t-calculated (0.35) is less than the t-critical at 5 and 10 percent respectively. Consequently, the relationship could be attributed to chance and probable factors. In conclusion, we fail to reject the alternative hypothesis of the existence of a positive relationship between bank performance and percentage of foreign shareholding. However, considerable caution must be exercised in attempting policy simulation since the variable failed the test of significance. The results also reveal that FORDIR is positively related to the performance of a bank. This is also in consonance with the apriori expectation. The result is also in agreement with studies previously carried out (Weisbach, 1998). The implication therefore, is that an increase in the number of foreign directors is likely to influence the bank's performance positively. Specifically, the results indicate that a unit change in the number of foreign directors will result in a change in banks' performance by 7.23 units. However, the results fail, also, the test of significance given that its t-calculated (0.38) is less than the t-critical at t and 10 per cent respectively. Decision wise, we fail to reject the alternative hypotheses of the existence of a positive relationship between bank performance and number of foreign directors. However, considerable caution must also be exercised in attempting policy simulation since the variable failed the test of significance. The DW-statistic of 1.8 shows that the serial correlation is absent in the model and that we should be more confident in the estimated coefficients obtained in the study.

4.0 Discussion

From the study, it was found that, according to Montgomery (1994) the presence of foreign investors in developing economies (including Nigeria) is largely responsible for the presence of foreign directors on boards of firms in which these investors have interest. This was in consonance with what was put forth by Carey (1994) that these foreign directors are needed on the boards of firms in which they have interest so as to have substantial and direct representation on the board. As earlier stated, there is a positive relationship between foreign directors present on a bank's board and bank performance. This is in consonance with the findings of Weisbach (2009), where foreign directors present on the board of banks were found to have higher efficiency in monitoring management, and thus reducing agency costs. The study also found out that foreign directors present on the board of a bank help to serve as a tool for proper management of their fund. Jensen *et. al.*, (1976) opine that managers need to be disciplined so that they will be less inclined to pursue self-strategizing behaviours; like increasing their pay packages and taking up negative net present value projects.

5.0 Conclusion

There has been a considerable increase in the amount of foreign investments in the Nigerian economy over the past few decades. This has led to the presence of foreign directors on the board of most firms in Nigeria. Using data from the Nigerian banking sector, this paper showed some positive performance effects of the presence of foreign directors on the board of banks in Nigeria. This point to the fact that, funds of foreign directors are usually managed by the foreign directors themselves; and going by the positive relationships between the dependent and independent variables, we can conclude that the presence of foreign directors on the board of banks paves way for better bank performance and invariably better management of the funds of foreign directors.

Based on the above result, it is recommended that:

1. Banks in Nigeria should encourage the appointments of more foreign directors on their boards, given the robust evidence that they act in tandem with the shareholders' interest and impact positively on banks' overall performance.

2. More foreign investment should be encouraged in the financial sector, and indeed, the banking sector of the economy. This can be achieved by relaxing the laws placed on foreign directors. The NIPC Act No. 16 of 1995, which allowed limit to the number of foreign directors on the board of firms in Nigeria, should be relaxed.

3. Since all the independent variables (BDMEM, FORSH and FORDIR) proxied in this study failed their test of significance, considerable caution should be exercised in attempting policy simulation in this regard.

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DATA USED TO RUN THE REGRESSION

	Banks	No. of B.O.D. Members	No. of Foreign Directors	Percentage of Foreign Shareholdings	R.O.A.
1.	Afribank Nig. Plc	9	-	-	2.4
2.	Bank PHB Plc.	16	-	-	1.9
3.	Diamond Bank Plc.	16	1	-	3.8
4.	Ecobank Plc.	11	-	-	0.49
5.	Fidelity Bank Plc	13	-	-	2.4
6.	FCMB Plc	12	3	1.8	3.0
7.	Intercontinental Bank Plc.	20	2	-	2.5
8.	Oceanic Bank Plc.	18	2	0.14	0.6
9.	Skye Bank Plc.	17	1	0.11	1.9
10.	Stanbic IBTC Plc.	18	8	86.8	3.1
11.	Sterling Bank Plc.	12	2	34.1	2.8
12.	United Bank for Africa Plc.	20	3	11.7	2.6
13.	Unity Bank Plc.	14	_	-	(6.1)
14	Wema Bank Plc.	7	-	-	(44.7)