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# Corporate Governance and Merger Activity in the Nigerian Banking Industry

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**ABSTRACT** This paper takes an explorative search into merger activity in the Nigerian banking industry and its impact in the sustenance of shareholder value via sound corporate governance structure. An attempt is made to draw lessons from United States experience in merger activity in the Nigerian banking industry which has as at the time of study recorded twenty -five (25) successful mergers arising from the regulatory demand for consolidation. The major finding revealed that the Banking Sector is partly responsible for the poor state of the Nigerian Economy through its support for the import – dependence nature of the economy rather than financing of sustainable economic development through shareholder values maximization. The data used are essentially secondary and the study suggests for instance, some steps to ensure improvements in corporate governance through the pursuit of shareholder value which managers, should uphold as guiding instruments for their job security.

## INTRODUCTION

There has been increasing realization that more action is needed on weak governance in various sectors of state and society in Nigeria, especially the economy. In recent years, this concern has been extended to the corporate sector. Until recently, not much was known about the state of corporate governance in Nigeria. A survey by the Securities Exchange Commission, which was reported in April 2003 and quoted in the Central Bank of Nigeria annual report of 2006 shows that corporate governance, is at a rudimentary stage in Nigeria. Only about 40% of quoted companies, including banks had recognized codes of corporate governance in place. Poor corporate governance is one of the major factors in virtually all the instances of financial institutions distress in the country.

To guide our discussions, two conceptualizations of the term ‘corporate governance’ are considered germane. The first sees corporate governance as the relationship of a company to its shareholders or, more broadly to society. The second sees corporate governance as being about promoting corporate fairness, transparency and accountability. Corporate governance can be described as a system by which corporations are directed, controlled and held to account. It embraces all forms of enterprises in the public and private sectors. In the Nigerian context, corporate governance may be seen to be concerned with the process by which corporate entities operating in the country, particularly Limited Liability Companies are governed. It is the exercise of power over the enterprise direction, the supervision and control of enterprise actions, the concern for the effect of the enterprise on other parties, the acceptance of a duty to be accountable and self-regulating within the status and jurisdiction of the Federal Republic of Nigeria.

Good corporate governance ideally, provides a level of disclosure and transparency regarding the conduct of corporations and their boards of directors that enables the supervision of their accountability while ensuring that they comply with their legal obligations and remissions, are accountable to share holders and responsible to stakeholders including employees, suppliers, creditors, customers and communities, and act responsibly regarding the environment.

The Country Review Report of Africa Peer Review Mechanism on Nigeria (2008) noted that the concept of Corporate Governance as an established practice did not emerge in Nigeria until November 2003 when the Nigerian Code of Corporate Governance was promulgated for Public Liability Companies. Prior to the promulgation, the Company and Allied matters Act of 1990 was the main legislative framework for corporate governance for Companies generally. It was the new Code of 2003 that established Corporate Governance as a rule binding on all companies and aiming at inculcating principles of corporate governance as enshrined in international standards on corporate governance. It seeks to

ensure transparency, accountability and fairness in the directorship and management of companies in Nigeria by providing guidelines on issues such as separating the rules of the CEO and the Chairman of the board, defining criteria for selection of directors and the composition and responsibilities of boards and the committees and transparency in financial and non-financial reporting.

In this paper, an attempt is made to explore the pattern of corporate governance in the banking sector since 2003, i.e. the mechanisms by which those institutions and their managers are governed, and how it might be altered or modified in the spate of recent waves of mergers and acquisition in the Nigerian banking ind-ustry.

### Mergers and Acquisitions

Mergers and acquisitions, before the Nigerian experience have certain trends and characteristics about them established over the last century. Empirical research further attests to these trends and characteristics.

A profusion of studies, for instance, has demonstrated that mergers seem to create share-holders value, with most of the gains accruing to the target company. Economic theory also provided many possible reasons for why mergers might occur even though research effort on the subject has been limited.

Most of these theories have been found to explain some of the mergers over the last century, and thus are clearly relevant to a comprehensive understanding of what drives acquisitions. In addition, some of these reasons for mergers appear to be more relevant in certain time periods and at certain places. In the United States, for example, antitrust laws as an active enforcement have made merger for market power difficult to achieve since the 1980s (the era of hostile takeovers) as only 14 percent of deals in that decade involved hostile parties.

Building up from the most consistent empirical features of merger activity over the last century, the trends suggest that merger might occur as a reaction to unexpected shocks in top industry structure. This feature lends credence to the situation of the Nigerian banking industry and the related issues seem to correspond to the intuition of practitioners and analysts that industries tend to restructure and consolidate in concentrated periods of time, that changes occur suddenly, and that the changes are hard to predict.

In our analysis of mergers and acquisitions, we aim to establish the linkage between the current dominance of shareholder value as a result of mergers and corporate social responsibility as corporate objectives to permanent improvement in corporate governance.

## HISTORICAL BACKGROUND

### The Nigerian Experience

Corporate governance practices in Nigeria generally reflect systemic governance problems, capacity constraints and ineffective implementation of laws which have led to limited economic growth. The private sector has been dogged by weaknesses inherent in its skewed structure, poor state of infrastructure, high cost and limited access to appropriate financing, insufficient domestic demand, low level of patronage by public sector institutions, domestic policies and environmental factors and investment flows.

Other serious challenges to the entrenchment of good corporate governance in Nigeria include complexities in the regulatory framework and effectiveness of the judiciary and oversight bodies. According to Ogwumike (2002), without sustained efforts to sustain the private sector as a target approach and improve corporate governance, sustainable wealth creation has been difficult to attain and poverty alleviation impossible.

Nonetheless, notable efforts have been made not only to tackle systemic governance issues in various sectors of the state and society but also to improve corporate governance in the country. The first significant step was the amendment of the Companies and Allied Matters Act on December 1, 1990 and the creation of the Corporate Affairs Commission. Also worthy of mention is the formation of the Committee on Corporate Governance of Public Companies in Nigeria in November 2003 whose mandate was to identify weaknesses in corporate governance practice in Nigeria and fashion out necessary changes that will improve Nigeria's corporate governance practices, such as enhancing corporate discipline, transparency and accountability. In a nutshell, the committee sought to align the practice of corporate governance in Nigeria with international standards and practices. Despite these efforts, corporate governance issues have not yet become a regular concern in Nigeria. In

the findings of the Country Review Report of Africa Peer Review Mechanism (2008), the subject is still new, the relevant codes having been promulgated fairly recently. Corporate social responsibility is not well understood and is widely viewed in terms of philanthropic gestures of goodwill rather than mandate attributes of corporate citizenship.

### Banking Sub-sector Restructuring

The programme of banking and insurance consolidation is the mainstay of financial sector reforms in Nigeria. Prior to the reforms, the financial sector was characterized by asset concentration and a low asset base. According to Soludo (2004), more than half of total bank assets were held by only 10 of the 89 banks. Meanwhile, the combined assets of the 89 banks in operation totaled a mere $18.0 billion. Furthermore, a substantial portion (20.8 percent) of the total money supply remained outside the banking system as a result of high inflation, a low level of public confidence in the sub- sector and inefficient intermediation. The savings deposit rate was a mere 3-5 percent, while the lending rate averaged 21-32 percent. A surveillance report in 2004 detected that 25 of the 89 banks were either marginally sound or unsound. Two of the banks did not make statutory returns. The banking industry was characterized by weak corporate governance, declining ethics, de-marketing of some banks and insider abuses. Many banks were heavily dependent on public sector deposits.

To redress the weaknesses in the sub-sector, the Central Bank of Nigeria in collaboration with other institutions e.g. the Nigeria Deposit Insurance Corporation, Securities and Exchange Commission and the Nigerian Stock Exchange embarked on a comprehensive bank consolidation programme. By the end of the programme in December 2005, only 25 banks had met the minimum capitalization requirements. Fourteen banks could not raise their capital base or merge with others and were subsequently liquidated.

The banking sub-sector restructuring had a positive impact on the financial health of the banks. The key outcomes include the emergence of 25 relatively well-capitalized banks, a fall in interest rates because of enhanced liquidity; improved intermediation efficiency of the banks leading to a fall in the ratio of currency outside the banking system from 21.4 percent in December 2005 to 14.2 percent by the end of December 2005; increased capacity of banks to finance big transactions with a single obligor limit; and dilution of bank ownership which enhanced potential to improve corporate governance.

Furthermore, with larger economies of scale, customers now stand to benefit from reduced bank charges. Since almost all the banks are quoted, the oversight of the Securities Exchange Commission and the Nigerian Stock Exchange has become industry wide. The Nigeria banking system is now the fastest growing in Africa. The World Bank Reports (2006) stated that two Banks, the first in sub-Saharan Africa, have successfully issued Eurobonds and some of the banks are on the verge of being listed on the London Exchange.

Further to these positive developments is the rapid growth of the capital market. The number of registered operators on the Nigerian Stock Exchange grew from 290 in 1999 to 581 in 2006, and securities listed on the Exchange increased from 268 in 1999 to 288 in 2006. The value of new issues (debt and equities) rose rapidly from N12.04 billion in 1999 to N702.15 billion in 2006.

In addition, the ratio of market capitalization to the Gross Domestic Product more than trebled from 9.4 percent in 1999 to 28.3 percent in 2006. Also, the Nigeria Stock Exchange All-Share Index, which is a veritable barometer of the health of the economy, rose almost tenfold between 1999 (5,266) and 2007 (over 47,000).

In spite of these impressive gains, the capital market of the Nigerian economy is still considered narrow and shallow, leaving enormous potential for growth and wealth creation.

## MAIN CAUSES OF CONSOLIDATION IN NIGERIAN BANKING SECTOR

Proponents of financial sector consolidation argue that institutions need size to spread and according to Alabi (1996), growing information technology and processing costs over larger revenue bases. Another key factor is the need for greater market capitalization, with governments and financial sector regulators accepting financial operators' arguments that greater size is crucial to cost-cutting and strong national institutions. Smaller countries are also encouraging consolidation to counter growing competition

from larger institutions in neighbouring countries. Nigeria is the most populous Black nation in the world with an estimated population of 140 million and the country is the 13th largest oil producing nations in the world. However, according to Osinubiu (2003), the state of the Nigerian economy and infrastructure is yet to reflect benefits of this position.

The banking sector is partly responsible for the state of Nigerian economy. It has reneged on its role of financing sustainable economic development by rather supporting the import-dependence nature of the economy which as Akpobasah (2004) noted had also become unsustainable due to foreign exchange scarcity. Most of the revenue generated by banks is import business-related. This is largely due to the highly fragmented nature and the weak capital base of Nigerian banks.

With internationalization of finance, size has become an important ingredient for success in the globalizing world. In the world of finance, Orji (1998) asserted that no country can afford to operate in isolation. The last few years have witnessed the creation of the world's banking group through mergers and acquisitions. The trend has been influenced by factors such as prospects of cost-savings due to economies of scale as well as more efficient allocation of resources; enhanced efficiency in resource allocation; and risk reduction arising from improved management.

## Operating Synergy

Consolidation of Nigerian banks has resulted to merging of banks giving rise to a large bank, which will use its operation synergies to generate higher net income. The stronger banks at the beginning of consolidation had assured most of the marginal banks that whatever shareholders' funds they had were not important but the synergy they would bring to bear in the operation of the bigger entity to emerge from consolidation effort was crucial. Such factors include the presence in areas where the smaller banks were and the stronger banks had no presence were being touted.

The consolidation of the banking sector according to Soludo (2004) has also been to modify the system of ownership structure of Nigerian banks, making it more widespread and better diversified. The emerging stakeholder of banking institutions are likely to demand higher level of job ethics, transparency and professionalism in the modus operandi of banking business, which will further promote better corporate governance and will consequently guarantee accountability in the Nigerian banking system.

## Share Holders Value

Currently, the average return on Invested Capital in the Nigerian banking industry as stated in the CBN (2006) Annual Report is 38%. To maintain this average Return on Invested Capital, banks will need to generate at least N9.5bn in profits before taxation. To sustain such performance, banks are forced to be creative in utilizing their universal banking licenses. Underserved market segments, especially the consumer market should be cultivated. Banks will also need to expand their operations beyond Nigerian market to participate in the regional and global financial market place. At it's most basic, creating shareholder value means that the market favours firms that increase the productive use of their assets by increasing turnover ratios, margins and profitability. Increasing sales growth adds shareholder value as long as reinvestment earns returns that exceed the firm's capital.

Conversely, firms without such opportunities destroy shareholder value by reinvesting and should return the money to shareholders through dividend increases or share buy-backs. These are largely motherhood statements in finance, but are often not reflected either in managerial policies or corporate culture.

## DISCUSSION OF THE NIGERIAN BANKING SECTOR ON COPORATE GOVERNANCE

There are five key objectives of concern in the area of corporate governance on which our assessment of the Nigerian banking sector is based. The five objectives are:

1. To promote an enabling environment and effective regulatory framework for economic activities.
2. To ensure that corporations act as good corporate citizens with regards to human rights, social responsibility and environmental sustainability.
3. To promote adoption of codes of good business ethics in achieving the objectives of the corporation.
4. To ensure that corporations treat all their

stakeholders includes (Shareholders, Employees, Communities, Suppliers and Customers) fairly.

5. To provide for accountability of corporations, directors and officers.

In assessing the performance of the Nigerian banking industry against these objectives, the findings of the African Peer Review Mechanism Country Review Report No 8 of 2008, will be our invaluable guide. The report established that legal and administrative measures exist in Nigeria to facilitate economic activities. The existing regulatory framework for banking, stock and security by markets are rated to be effective while those for micro- finance and corporative societies are rated moderately effective. This is not too surprising because awareness among banks and listed companies is better than within smaller enterprises. This is mainly due to the joint efforts by Central Bank of Nigeria and Security Exchange Commission to promote good corporate governance. Key among the effort by Central Bank of Nigeria is the move made in 2005 to consolidate and constrict ill-supervised banks. Post consolidation, challenges relating to integration of cultures and processes remain and the Central Bank of Nigeria continues to issue codes and guidelines to assist banks. For its part, the Security Exchange Commission launched an initiative in December 2006 to rate companies on good corporate governance and give formal recognition to deserving companies for their performance.

On the second objective, there is a high level of awareness of corporate social responsibility among firms operating in Nigeria but little significant actions. The emphasis is more on token 'community development', less on socially employee relations and almost non-existent socially responsible products and processes. The understanding and practice of corporate social responsibility is still largely philanthropic and altruistic. The challenge here is to bring corporate social responsibility in line with the global trend. A corporate governance framework reform is needed to orientate Nigerian firms towards social considerations.

The assessment of corporate integrity in the regard of objective three seems reasonable for the banking industry, though fraught, somewhat, with challenges. There are established, effective bodies promoting codes of good business ethics. These include the Securities and Exchange Commission, Nigerian Stock Exchange, Central Bank of Nigeria, National Insurance Commission, Independent Corrupt Practices Commission and Economic and Financial Crimes Commission.

Though there are protective provisions as safeguards in corporate governance with regard to objective four, nevertheless, there has been increasing activism by shareholders to defend their rights. The proliferation of shareholders association is an indication of dissatisfaction of the investing public with the performance of directors and auditors in companies in which they have investment. There is need to establish well regulated shareholders associations that are alive to their responsibilities as watch dog of Board and Management of companies and ensure they imbibe best corporate governance practices of accountability, transparency and full disclosure of financial information, which are essential in generation good returns to shareholders.

Finally on objective five, supervisory or regulatory authorities have been established to monitor the compliance of corporations within the prescribed reporting requirements. For instance, the Central Bank of Nigeria's code of corporate governance for banks in the post-consolidation era makes elaborate provision to ensure industry transparency, due process, data integrity and disclosure requirements. A corporate governance compliance status report is required to be included in the audited financial statements. These have been positively affecting the improvement of corporate governance standards in general.

## SHAREHOLDERS VALUE AND CORPORATE SOCIAL RESPONSIBILITY AS CORPORATE OBJECTIVES TO PERMANENT IMPROVEMENT IN CORPORATE GOVERNANCE

Shareholders are individuals or group of persons who purchase shares (whether in small or large sums) of a company. Being part owner of a company, a shareholder is entitled to take part in decision making for the running of the company as well as to access information regarding the performance of the company. Shareholder can vote on company issues at Shareholders' Annual General Meeting and other meetings.

The CBN Statistical Bulletin (1998) stated that in Nigeria, there are over 20 million shareholders who own share in public and private companies. Many of these are minority shareholders who are generally ignorant of their rights ad re-

sponsibilities. When they become aware, they often adopt passive and inexperienced approach especially due to the lack of established good corporate governance practice. Even when they do take action, they are usually not familiar with their rights, options and the appropriate approaches to air their grievances.

Provision for shareholders' safeguards in corporate governance in Nigeria is articulated in two broad framework. These are

(i) Provisions within the Company Law; and

(ii) Provisions within the Securities and Exchange Commission Act. The need for safeguards the rights of shareholders in corporate governance reveals two broad levels of protection. These are;

- Safeguards between the shareholders in general meeting and the Board of Directors and
- Safeguards between the minority shareholders and majority shareholders and the management (for minority protection). The corporate governance framework provides some safeguards for the shareholder' protection at the two broad levels of relationship in corporate governance.

The primary corporate legislation is the Companies and Allied Matters Act 1990 which among other things, makes many provision for company formation, operation/ administration regulation and liquidation. Shareholders' safeguards in corporate governance in Nigeria are contained in the same act of 1990 and the Investments and Securities Act 1999.

Nevertheless, there has been increasing activism by shareholders to defend their rights in recent times. The proliferation of shareholders association is an indication of dissatisfaction of the investing public with the performance of directors and auditors in companies in which they have investment.

**Corporate Social Responsibility**

The Concept of Corporate Social Responsibility (CSR) may be seen as the moral and ethical content of managerial and corporate decisions over and above the pragmatic requirements imposed by legal principle and the market economy. People generally feel that business and other organizations have social obligations and responsibilities. Social responsibility includes obligations that an organization owes the general public and to specific interest groups and they arise from organizational activities that affect society to a greater degree than do the organizations ordinary affair. The concept of corporate social responsibility assumes that firms have some social duties to render to the society. In other words, firms have a duty to conduct themselves in the interest of society as a whole.

In Nigeria, society has been placing increased demands on big business organizations for greater social responsibilities in the last decade. There has been pressure on business to be involved in solving social and economic problems. The concerns include employee welfare, working condition, pollution, product safety, marketing practices, employment and community development among others.

One of the main problems surrounding the entire business environment in Nigeria appears to be clearly defining what social responsibility is as well as deciding what society should reasonably expect from the business. There is also a high level of awareness of corporate social responsibility among operating firms but little significant actions. As rightly observed in the Country Review Report of Africa Peer Review Mechanism on Nigeria, the emphasis is more on token 'community development', less on socially responsible employee relations and almost nonexistent socially responsible products and processes. The understanding and practice of corporate social responsibility is still largely philanthropic and altruistic. The challenge is to bring corporate social responsibility in Nigeria in line with the global trend.

Notwithstanding the problems, demands for socially responsible business behaviour will continue and probably increase as many business organization come under increasing pressure to respond to present challenges. A corporate governance framework reform is needed to orientate Nigeria firms towards social considerations.

## CONCLUSION AND RECOMMENDATION

Given that gains to shareholders from merger/ takeover activity are real economic gains from efficient re-arrangement of resources, we are inclined to defend the traditional view that mergers improve efficiency and that the gains to shareholders at mergers announcement accurately reflect improved expectations of future cash flow performance. But the conclusion must be defended from several challenges.

A first challenge relates to methodological

issues yielding negative drift in acquiring firm stock prices following merger transactions, which would imply that the gains from mergers are overstated or non-existent. The fundamental problem here also relates to the task of obtaining a precise measure of long-term expected returns, in order to measure long-term abnormal returns reliably. Empirical assets pricing models are fraught with a number of limitations.

The second challenge relates to the inability of current research efforts to detail the underlying source of the gains from mergers. Here, the large sample nature of most studies, which tend to combine transactions with different motivations, and the inherent noisiness of the accounting data have made it difficult for traditional research methods to address the issue. The positive effect of the merger could be recognized by the stock market, but it is difficult for economic researchers to identify the sources of the overcome of these limitations and to understand better the sources of value creation ad destruction arising from mergers, via examination of more detailed information.

A third challenge to the claim that mergers create value stems from the finding that all of the gains from mergers seem to accrue to the target firm shareholders. We believe that in an efficient economy, there would be a direct link between causes and effects, that mergers would happen for the right reasons, and that their efforts that mergers do not seem to benefit acquirers provides reason to worry about this empirical analysis.

Part of the issue here may be that an acquiring firm can seek a merger for a mix of reasons. Many firms mention mergers as their main strategic tool for growth and success, and point to possible scale economies, synergies, and greater asset management efficiency. Alternatively, there is the somewhat contradictory evidence that mergers can be evidence of empire-building behaviour by managers. Most observers, in addition, have viewed the mergers in the Nigerian banking sector as regulation-induced, as the easiest path for banks to meet up with the recapitalization directive, or face the risk of going under. Whatever the reasons, if mergers could be sorted out by true underlying motivations, it may be that those which are undertaken for good reasons do benefit acquirers, but in the average statistics, these are cancelled out by mergers undertaken for less benign reasons.

Managers and directors of the mega banks in Nigeria should note that a more market-oriented style of corporate governance is here to stay. This is more so with the booming of the nation's capital market. The growth of mutual funds and institutional investors seems certain to continue over the next couple of decades. The market-based system of corporate governance also seems to have a potentially powerful role to play as the forces of deregulation, globalization, and information technology continue to sweep across the world economy.

Managers should vigorously pursue shareholder value creation, at least as a means to assuring continual provision of capital. The use of equity-based compensation enhances this pursuit.

An effective means of reducing agency costs arising from asymmetric information is by share repurchase as a way of compensating shareholders for their ownership stake in the banks.

As in other developed economies, such as the US, Europe and Japan, the Nigerian regulatory authorities could eliminate a substantial tax penalty on executive stock options. This would engender the use of equity-based compensation for banks' executives.

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