THE EFFECT OF CORPORATE GOVERNANCE ON AGENCY COSTS OF LISTED COMMERCIAL BANKS IN NIGERIA.

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Abstract

This study investigates the impact of corporate governance on agency costs for a sample of twelve (12) listed commercial banks in Nigeria from 2011 to 2021. Corporate governance was measured by board size, board independence, and gender diversity, while agency costs were proxied by the expense ratio. The data was analyzed using a fixed-effects estimation technique. The findings show that board independence and gender diversity do not significantly affect agency costs. However, board size significantly negatively affects the agency costs of listed commercial banks in Nigeria. The study recommends increasing the board size of listed commercial banks in Nigeria. A larger board allows for the inclusion of directors with a wider range of skills, knowledge, and experiences.

Keywords: Agency costs, Corporate governance, Fixed effects, Board

1.0 Introduction

In the book, the Wealth of Nations, Smith (1776) introduced the principal-agent relationship. He pointed out that company managers cannot oversee their businesses with the same level of care as sole traders or partnerships, where the managers are also the owners. This separation between ownership and control has remained a topic of interest among researchers worldwide (Nguyen et al., 2020). Jensen and Meckling (1976) define an agency relationship as a contract in which a principal hires an agent to act on his behalf, giving the agent some decision-making authority. The principal's role is not to control the company's upstream or plan strategies but to

limit the agent's discretion and ensure compliance with the contract. Agents may prioritize their interests over the principal's because they have control and power.

Agency costs refer to the potential conflicts of interest and associated costs that arise between the owners of a company (shareholders) and its managers. These costs are incurred when managers act in their own self-interest or pursue personal goals that are not aligned with the interests of shareholders (Nguyen et al., 2020). Agency costs can take on different forms, such as managers prioritizing their own status or goals of expanding their influence, excessive use of company perks, making non-optimal investment decisions, engaging in accounting mismanagement, or committing corporate fraud. Unfortunately, these actions can lead to negative effects such as the loss of shareholders' wealth and negative impacts on other company stakeholders (Gul et al., 2012).

Corporate governance also refers to the system by which firms are directed and controlled. It includes the regulations that govern a company's internal operations, such as the relationship between the owners and managers, who are responsible for the company's day-to-day management (Cadbury report, 1992; Adegbite, 2008). Implementing corporate governance systems helps to address agency problems, safeguard shareholders' interests, and maintain the organisation's structure. Good corporate governance ensures that boards and managers are accountable for managing corporate assets and provide effective managerial oversight. Effective corporate governance mitigates corrupt practices in business dealings, creating an environment resistant to the growth and establishment of corrupt practices within a company. While corporate governance may not be a certain safeguard against corruption, it can enhance the likelihood of timely detection and elimination of corrupt practices (Ijeoma & Ezejiofor, 2013; Eboiyehi & Iyiegbuniwe, 2018).

According to Bebchuk and Weisbach (2010) and Paniagua et al. (2018), the board of directors is an important control mechanism that should represent and prioritize the best interests of shareholders. Donaldson and Davis (1991), Jensen (1993), and Allam (2018) argued that the board of directors oversees internal control mechanisms that prevent managers from engaging in self-interested behaviours, actions, or decisions. The board is the top authority that ensures proper conduct within the organization. The board of directors has several responsibilities, including selecting, monitoring, advising, and evaluating top management. Board members also determine compensation and take corrective action if deviations occur. According to governance literature, there are certain characteristics that a board should have to carry out its roles effectively. These characteristics include board size, board independence, and gender diversity, these characteristics significantly impact the board's performance.

Opportunistic managers have misappropriated organisational resources for personal gain rather than prioritising shareholders wealth maximisation. Effective governance strategies can alleviate conflicts of interest that may arise between the principals and agents, thereby improving the organisation's overall value. Previous studies on the correlation between corporate governance and agency costs have yielded inconclusive results (Wellalage & Locke, 2013; Eboiyehi & Iyiegbuniwe, 2018; Vijayakumaran, 2019; Čalopa et al., 2020; Ain et al., 2021). This study investigates the correlation between corporate governance and agency costs to make a valuable contribution to the existing body of literature.

The study's main objective is to examine the effect of corporate governance on the agency costs of listed commercial banks in Nigeria while the specific objectives are to:

i. determine the effect of board size on agency costs of listed commercial banks in Nigeria.
ii. determine the relationship of board gender diversity on agency costs of listed commercial banks in Nigeria.

iii. investigate the impact of board independence on agency costs of listed commercial banks in Nigeria.

2.0 Review of Literature

The study is based on agency theory and the concept of agency theory revolves around the connection between an organization's owners or shareholders (known as the principal) and its managers or employee (known as the agent). The theory highlights the possibility of conflicts of interest arising when the principal delegates decision-making authority to the agent (Jensen & Meckling, 1976; Uchenna et al., 2017). Agency theory states that the principal-agent relationship is marked by information asymmetry. The agent typically has more knowledge of their actions and intentions than the principal. Information asymmetry can cause a difference in interests between the principal and agent. The principal desires that the agent will act in the best interest of the principal, maximizing shareholders value. However, the agent may have different personal goals or motivations that do not align with the principal's (Mallin, 2019).

The principal-agent problem arises because the agent may not always act in the principal's best interests due to self-interest, risk aversion, or differing objectives. For example, managers may prioritize job security, power, or personal financial gain over the organization's long-term profitability (Solomon, 2020). The principal-agent problem is particularly relevant when the agent is not the organization's owner, such as in large corporations. To solve the agency problem, agency theory recommends using different methods to ensure that the principal and agent have aligned interests. These methods include incentive alignment, monitoring and control, contracts and agreements, and ownership structure (Mallin, 2019)

Wellalage and Locke (2013) examine the impact of board gender diversity on company financial performance and agency costs. The sample consists of 88 non-financial firms listed on the Colombo Stock Exchange (CSE) from 2006 to 2010. They found a significant positive relationship between agency costs and board gender diversity.

Eboiyehi and Iyiegbuniwe (2018) employed the fixed-effect approach to examine the impact of ownership structure and corporate governance on agency costs for a sample of 57

manufacturing companies listed on the Nigerian Exchange Group (NGX) between 2007 and 2017. The findings showed that board size and independence have an insignificant impact on agency costs.

Vijayakumaran (2019) employed the Generalised Methods of Moments (GMM) system to examine the effects of ownership structure and corporate governance on agency costs. The sample size comprised 1420 non-financial firms listed in China between 2004 and 2010. The agency costs were measured by asset utilisation and expense ratio. The findings show that board independence and size do not affect agency costs.

Using a random-effect estimating approach, Čalopa et al. (2020) examined the effects of board size and ownership concentration on the agency costs sample of 109 non-financial enterprises in Croatia from 2014 to 2018. The agency costs were proxied by the asset utilisation ratio. The findings show a significant inverse relationship between agency costs and board size.

Ain et al. (2021) employed the two-stage least squares (2SLS) approach to investigate the influence of board gender diversity on agency costs. The sample comprised 23,340 firms listed on the Shenzhen Stock Exchange and the Shanghai Stock Exchange during the period spanning from 2004 to 2017. They found a significant inverse correlation between board gender diversity and agency costs.

3.0 Methodology

The research method employed is an ex post facto design. The sample comprises twelve (12) commercial banks listed on the NGX from 2012 to 2021. The data set utilized in this study is derived from audited financial statements made available to the public by sample commercial banks.

Model Specification

The model employed was modified and adapted from the study of Ain et al. (2021). The following are the panel multiple regression models with an error term (μ):

$$OPEX_{it} = \beta_0 + \beta_1 BI_{it} + \beta_2 BS_{it} + \beta_3 BG_{it} + \beta_4 LQ_{it} + \beta_5 MG_{it} + \beta_6 AQ_{it} + \beta_7 CA_{it} + \beta_8 FS_{it} + \mu_{it} \quad \ldots (1)$$

Where:

OPEX = Agency Cost

BI = Board Independence

BS = Board Size

BG = Board Gender Diversity

LQ = Liquidity

MG = Management Quality

AQ = Assets Quality

CA = Capital Adequacy

FS = Firm Size

μt = error term

β_0, β_1, β_2, β_3, β_4, β_5, β_6, β_7, and β_8 = Parameters

3.1 MEASUREMENT OF VARIABLES

Variable	Measurement	Sources
Dependent variable		
Expense ratio	the ratio of operating expenses to annual sales	Ang et al. (2000) Vijayakumaran (2019)
Independent variables		
Board Size	total number of board members.	Ogege and Boloupremo (2014) Čalopa et al. (2020)
Board Gender Diversity	the ratio of the number of women to the total number of directors on the board	Wellalage and Locke (2013) Aslan and Kumar (2014)
Board Independence	the ratio of the number of non-executive directors to the total number of directors on the board	Allam (2018) Malik (2012)
Control Variables		
Capital Adequacy	(tier 1 capital + tier 2 capital)/ risk-weighted asset	Umer et al. (2021) Kulshrestha and Srivastava (2022)
Assets Quality	expenses/ income ratio	Thisaranga and Ariyasena (2021) Kulshrestha and Srivastava (2022)
Management Quality	employees/total revenue	Samuel (2018) Ghazi and Tayachi (2021)
Liquidity	liquid assets/ total assets	Ledhem and Mekidiche (2020) Altay (2021)
Firm Size	it is measured as a natural logarithm of total assets	Vijayakumaran (2019) Musteen et al. (2009)

4.0 DATA ANALYSIS

4.1. Descriptive statistics

The mean value of agency costs is 5.67%, with a standard deviation of 0.59%. In contrast, the minimum and maximum values are 4.19% and 6.68%, respectively. The mean value of the board size is 62 members, with a standard deviation of 12 members. In contrast, the minimum and maximum board size are 37 and 94 members, respectively. The mean value of board independence is 18.52%, with a standard deviation of 10.90%. In contrast, the minimum and maximum board independence is 0% and 50%, respectively. The mean value of board gender

diversity is 5.92%, with a standard deviation of 10.90%. In contrast, the minimum and maximum gender diversity are 1% and 16%, respectively.

Table 4.1: Descriptive statistics

	OPEX	BS	BI	BG	FS	LQ	MG	AQ	CA
Mean	5.676	61.590	18.520	5.992	13.644	67.0795	5.5094	41.925	4.201
Max	6.680	93.750	50.000	16.000	21.000	161.214	17.974	64.230	39.677
Min	4.190	36.840	0.000	1.000	6.000	31.126	1.121	5.720	-1.547
STD.	0.588	12.384	10.904	2.385	3.225	14.545	2.614	10.217	9.657
OBS	132	132	132	132	132	132	132	132	132

Source: Author's Computation, 2023

4.2 Correlation analysis

Table 4.2 presents the correlation matrix. We use Pearson's coefficient of correlation to examine the existence of correlation among variables. The result revealed a positive correlation between agency costs and capital adequacy (0.556) and a negative correlation between agency costs and **Management efficiency** (-0.580).

Table 4.2 Correlation Matrix

	OPEX	BG	BI	BS	FS	LQ	MG	AQ	CA
OPEX	1.000								
BG	-0.046	1.000							
BI	0.249	-0.014	1.000						
BS	-0.093	0.086	0.013	1.000					
FS	0.114	0.219	0.053	-0.406	1.000				
LQ	-0.166	-0.114	-0.054	-0.116	-0.107	1.000			
MG	-0.580	0.074	-0.197	-0.004	-0.036	-0.077	1.000		
AQ	-0.069	-0.114	-0.059	-0.163	0.095	-0.089	0.180	1.000	
CA	0.556	-0.289	-0.026	-0.321	-0.075	0.056	-0.367	0.036	1.000

Source: Author's Computation, 2023

4.3 Variance Inflation Factor (VIF)

The Variance Inflation Factor (VIF) test is used to test for multicollinearity. Table 4.3 shows that none of the variables exceeded the benchmark 10, with the highest VIF being 1.54 and the lowest being 1.06. The mean VIF is 1.28, which is also less than the benchmark. These values indicate that the model is free from the problem of multicollinearity.

Table 4.3 Variance Inflation Factor

Variable	VIF	1/VIF
BS	1.54	0.650
CA	1.51	0.660
FS	1.41	0.709
MG	1.32	0.755
BG	1.18	0.848927
AQ	1.10	0.911
LQ	1.08	0.929
BI	1.06	0.941
Mean VIF	1.28	

Source: Author's Computation, 2023

The results of the Hausman Test are shown in Table 4.4. The p-value is less than 0.05; this implies that the null hypothesis (random effect) is rejected in favour of the alternative hypothesis (fixed effect). Therefore, the fixed effect method is appropriate for drawing conclusions.

The R2 value is 87%. This implies that the three independent variables explain at least 87% of the variability in the agency costs of the studied Nigerian commercial banks.

Table 4.4 Regression Results

Variables	POOL	FEM	REM
C	5.732***	5.128***	5.321
p-value	0.000	0.000	0.000
BG	0.0167	0.013	0.015
p-value	0.295	0.224	0.143
BI	0.009***	0.003	0.006***
p-value	0.006	0.267	0.012
BS	0.004	-0.004*	-0.001
p-value	0.266	0.096	0.538
FS	0.023*	0.021**	0.023***
p-value	0.071	0.033	0.009
LQ	-0.007***	0.003*	-0.001
p-value	0.003	0.059	0.478
MG	-0.085***	-0.007	-0.036***
p-value	0.000	0.509	0.000
AQ	-0.000	0.005**	0.002
p-value	0.806	0.040	0.352
CA	0.030***	-0.002	0.028***
p-value	0.000	0.843	0.000
F-statistic	20.271***	41.155***	6.639
p-value	0.000	0.000	0.000
R-squared	0.569	0.875	0.302
Hausman Test	106.264***	106.264***	
p-value	0.000	0.000	

Source: **Author's Computation, 2023**

(1) bracket {} are p-values (2) *, **, *, implies statistical significance at 1%, 5%, and 10% levels respectively**

Board Size: The results show that board size (beta = --0.004; P-value = 0.096 < 0.10) significantly negatively affects agency costs. This implies that an increase in board size will lead to a fall in agency costs of listed commercial banks in Nigeria. This result is consistent with Aziz et al. (2015) and Čalopa et al. (2020), who found a significant negative relationship between board size and agency costs. However, the results contradict the findings of Aslan and Kumar (2014), who found a significant positive correlation between board size and agency costs.

Board Gender Diversity: The results show that board gender diversity (beta = 0.013; P-value = 0.224 > 0.05) insignificantly positively affects agency costs. This implies that board gender diversity does not impact the agency costs of listed commercial banks in Nigeria. This result aligns with Jurkus et al. (2011), who found an insignificant relationship between board gender diversity and agency costs. Nevertheless, the results contradict the findings of Wellalage and Locke (2013), who found a significant positive correlation between gender diversity and agency costs.

Board Independence: The results show that board independence (beta = 0.003; P-value = 0.267 > 0.05) insignificantly positively affects agency costs. This implies that board independence does not impact the agency costs of listed commercial banks in Nigeria. This result aligns with Allam (2018) and Vijayakumaran (2019), who found an insignificant relationship between board independence and agency costs. However, the results contradict the findings of Gul et al. (2012) and Yegon et al. (2014), who found a significant positive correlation between independence and agency costs.

5.0 Summary, Conclusion and Recommendations.

The study examines the effect of corporate governance on agency costs for a sample of 12 commercial banks listed on the Nigerian Exchange Group (NGX) from 2011 to 2021. Corporate governance was measured by board size, independence, and gender diversity, while agency costs were proxied by the expense ratio. The control variables were firm size (proxied by the natural logarithm of total assets), capital adequacy, asset quality, liquidity, and management quality. The data was analysed using a fixed-effects estimation technique. The findings show that board independence and gender diversity do not significantly affect agency costs.

In contrast, board size significantly negatively affects the agency costs of listed commercial banks in Nigeria. The study recommends increasing the board size of listed commercial banks

in Nigeria. A larger board allows for the inclusion of directors with a wider range of skills, knowledge, and experiences. This diversity can bring fresh perspectives and a broader set of expertise to the table, enhancing the board's ability to make well-informed decisions. Furthermore, with more directors, the board can benefit from increased debate and discussion during meetings. Diverse opinions and viewpoints can lead to more robust decision-making processes as different perspectives are considered and potential risks and opportunities are thoroughly evaluated.

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