THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

BY

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DECLARATION

This research project is my original work and has not been submitted for examination in any other university.

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This research project has been submitted for examination with my approval as the University supervisors

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DEDICATION

I dedicate this research project to my family members. To my late dad, Joshua Miseda, you did not labor in vain. To my mother, Rosebell Miseda your teachings and ceaseless support is always cherished. To my wife Irene and sons Franc and Austin you are the pillar that I will always lean on, this project would not have been successfully completed without your enormous support, love and patience.

ABSTRACT

The study examined the Corporate Governance factors and Financial Performance of commercial banks in Kenya. The study aimed at establishing the effects of corporate governance practices and policies on financial Performance of commercial banks.

A cross sectional and analytical research design was in this study. The population involved in this study was all the 44 commercial banks in Kenya. A sample ratio of 0.3 was used to obtain sample representation of the entire population. In this case, 13 CEOs from the sampled banks were subjected to the study. Primary data were obtained by administering questionnaires to CEOs of the sampled banks. Secondary sources were also used to obtain information; data from the published annual reports and company sources spanning five years.

The content validity of the two instruments of data collection was assured by ensuring that each of the items in the questionnaire and interview schedule addressed specific contents and objectives of the study. Statistical Package for Social Scientists (SPSS) was used and Spearman Correlation Coefficient and Multiple Regression Analysis to determine the magnitude of the relationship and prediction of financial performance respectively were applied. It was found out that corporate governance play an important role on bank stability, performance and bank's ability to provide liquidity in difficult market conditions. From the findings, corporate governance factors (CGPR, CGPO, DPP and SRR) accounts for 22.4 % of the financial performance of commercial banks, derived from adjusted R square value of the regression test.

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ABBREVIATIONS

BODs :   Board of Directors

CAR   :   Capital Adequacy Ratio

CBK   :   Central Bank of Kenya

CCG   :   Center for Corporate Governance

CGPR :   Corporate Governance Practice

CGPO :   Corporate Governance Policies

CEO   :   Chief Executive Officer

CIFAR: Center for Intentional Financial Analysis and Research

CMA   :   Capital Markets Authority

DPP   :   Disclosure Policies and Practices

FIs   :   Financial institutions

KCB   :   Kenya Commercial Bank

NPM   :   Net Profit Margin

NSE   :   Nairobi Stock Exchange

ROA   :   Return on Asset

ROE   :   Return on Equity

PER   :   Price Earning

SAP   :   Structural Adjustment Programmes

SRR   :   Shareholder's Rights and Responsibility

VAR   :   Value at Risk

CHAPTER ONE

INTRODUCTION TO THE STUDY

1.1 Background to the Study

This chapter contains the background, statement of the problem, objective, research questions and scope of the study. This chapter gives a basis for the entire study. In a nutshell, corporate governance is the set of processes, customs, policies, Laws and institutions affecting the way a corporation is directed, administered or controlled.

1.1.1 Corporate Governance

Adams &Mehran, (2003) define corporate governance as "the mechanism through which stakeholders (shareholders, creditors, employees, clients, suppliers, the government and the society, in general) monitor the management and insiders to safeguard their own interests." Morin and Jarrel (2001) define it as follows: "It is a framework through which monitors and safeguards the concerned actors in the market (managers, staff, clients, shareholders, suppliers and the board of administration." It is management through which the company is guided and monitored for the purpose of striking a balance between its interests, on the one hand, and the interests of other related parties such as investors, lenders, suppliers and clients in addition to the environment and society."

In the banking industry, corporate governance involves the way banking institutions' business and affairs are managed by the board of administration and the top management, which affects how the bank works out the bank's objectives, plans and policies, taking into consideration making appropriate economic returns for founders and other

shareholders, day-to-day work management, protection of the rights and interests of recognized stakeholders (shareholders and depositors), companies' commitment to sound and safe professional behaviors and practices which are in conformity with regulations and legislations, (Linyiru, 2006).

Corporate governance is a multi-faceted subject. An important theme of corporate governance deals with issues of accountability and fiduciary duty, essentially advocating the implementation of guidelines and mechanisms to ensure good behavior and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare. There are yet other sides to the corporate governance subject, such as the stake holder's view, which calls for more attention and accountability to players other than the shareholders e.g. the employees or the environment, (Awino, 2011). Recently there has been considerable interest in the corporate governance practices of modern corporations, particularly since the high-profile collapses of large U.S. firms such as Enron Corporation and WorldCom (Nambiro, 2007).

1.1.2 Financial Performance

Performance may be defined as the reflection of the way in which the resources of a company (bank) are used in the form which enables it to achieve its objectives. According to Heremans, (2007), financial performance is the employment of financial indicators to measure the extent of objective achievement, contribution to making available financial resources and support of the bank with investment opportunities.

Rutagi, (1997) defines financial performance as to how well an organization is performing. Other researchers define performance of the organization as the extent to which an organization achieves its intended outcome, Namisi, (2002).The general assumption among both researchers and practitioners is that effective boards lead to effective organization. From either an internal long-term profitability or external shareholder perspective, there is an indication that good boards may be able to add value to the organization, Epstein et al., (2003).

1.1.3 Determinants of Financial Performance in Commercial Banks

These are factors which play a role in shaping the financial status of a company. Most studies divide the determinants of commercial banks' financial performance into two categories, namely internal and external factors. Internal determinants of profitability, which are within the control of bank management, can be broadly classified into two categories, i.e. financial statement variables and nonfinancial statement variables, (Linyiru, 2006). While financial statement variables relate to the decisions which directly involve items in the balance sheet and income statement; non-financial statement variables involve factors that have no direct relation to the financial statements. The examples of non-financial variables within the this category are number of branches, status of the branch (e.g. limited or full-service branch, unit branch or multiple branches), location and size of the bank, Sudin (2004).

External factors are those factors that are considered to be beyond the control of the management of a bank. Among the widely discussed external variables are competition, regulation, concentration, market share, ownership, scarcity of capital, money supply, inflation and size. Sudin (2004). The government owned bank for instance, suffers incessant/frequent changes in board membership and many appointments were made based on political affiliation rather than expertise consideration. Consequent upon this, board members saw themselves as representative, of political parties in sharing the national cake emanating thereof and thus, ascribed their loyalty to the party members rather than the proper running of the bank itself. On the side of the privately-owned banks, shareholders constituted a problem.

As a result of the insiders abuse of recruiting inexperienced and incompetent personnel to hold key positions in the bank, deterioration of management culture and weak internal control system instigated by the squabbles among the high rank management decision making team, and non- compliance with laws and prudential standards, mismanagement seemed to play a major role in bank failure in Kenya. Bank losses increased and management resorted to hiding the losses in order to buy time and remain in control, (Ogumu, 2006). The banking industry being the nerve centre of the economy is invariably affected by economic and political environment/condition of the country. For instance the Structural Adjustment Programme (SAP) introduced in 1986 led to a wide range of economic reforms that affected the banking system.

Also political situation like the political crisis like the disputed election in 2008, led to massive withdrawal of funds that affected banks (especially) those around affected regions, (CBK, 2008). The regulatory and supervisory measures of the CBK are unable to keep pace with the rapid changes in the banking industry. The CBK brief (2007) noted that the ability of the CBK to perform its regulatory role had in the past been affected by political leadership and corruption in the former regime. Ogumu, (2006) in discussing the challenges of bank liquidation and deposit payoff, noted that closing a bank is a specialized job requiring services of technically skilled people in banking, accounting, legal, quantity surveying, estate management, information management and technology as well as facility support and also noted that political instability constituted a problem to its supervisory function.

1.1.4 Relationship between Corporate Governance and financial performance

Two broadly defined theories co- exist in the corporate governance literature. One stresses the discipline of the market, claiming that threat of hostile takeovers and leveraged buyouts in firms was sufficient to ensure full efficiency. Where managers neglect to invest in those projects that add value to the firm and its shareholders but divert recourses to their own benefit, the financial markets act to restore good governance. A number of mechanisms have been suggested, such as removing senior managers in poorly performing firms, (George, 2011); demanding cash flow payments in the form of debt service; and linking executive compensation to performance, including equity and options Jensen, (1986).

Matama, (2005) in the study of Corporate Governance and financial performance on selected commercial banks, obtained a positive relationship between Corporate Governance and financial performance. Masibo, (2005) researched on Board Governance and firm performance of selected state owned corporations and in listed organizations on Uganda Securities Exchange, obtained a positive direct and indirect link between Board Governance and Firm financial Performance through Board Effectiveness. Piesses, (2005), carried out empirical research on Corporate Governance and firm performance in an international perspective and obtained conflicting results on the link between Corporate Governance and Firm performance.

1.1.5 Kenyan Context

Kenya currently has 44 licensed commercial banks and one mortgage finance company. Of these 44 institutions, 31 are locally owned and 13 are foreign owned. The government of Kenya has a substantial stake in three of Kenya's commercial banks, (Okumu, 2006). The remaining local commercial banks are largely family owned. Commercial banks in Kenya accept deposits from individuals and turn a profit by using the deposits to offer loans to businesses with a high interest rate.

1.1.6 Corporate Governance and commercial Banking in Kenya

The subject of corporate governance in Kenya has been top of the agenda for many years. Despite tight regulatory framework, corporate governance continues to weaken in Kenya to some extent. Kenya in particular, concern was raised specifically on the way in which organizations were managed and controlled. According to Centre for Corporate

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Governance of Kenya (CCG) (2004), focus on corporate governance in the financial sector is crucial mostly because the banking industry became highly exposed to scrutiny by the public and many lessons were learnt because of the risks involved including adverse publicity brought about by failings in governance and stakeholder relations for instance, the collapse of banks such as Euro bank, Trust bank and Daima bank just to mention a few cases (CCG, 2004).

Kenya's corporate governance system was highly influenced by two factors: after the government relaxed rules that governed issuance of licenses to banks in 1982 and by the privatization process that began in the 1980's and gained momentum in the 90's. This led to the growth of many banks that did not put into practice proper corporate governance structures resulting into poor governance and management culture in the industry (Mwangi, 2002). A case in point was it the year 1984 when the Rural Urban Credit Finance was placed in interim liquidation. The Government of Kenya through the Central Bank made changes in the Central Bank act and the banking act to curb instability in the banking industry. This was for example, through raising the capital requirements and the creation of the Depositors Protection Fund.

Regardless of efforts made to streamline the banking sector, many banks have been liquidated or put under receivership. The collapse was due to weak internal controls, poor governance and management practices. For example, Continental Bank of Kenya and Continental Credit Finance Ltd collapsed in 1986. In 1987 Capital Finance went under. The Government then formed Consolidated Bank by merging seven banks that had

collapsed (Nambiro, 2007). Various reasons were given that may have contributed to the collapse of banking institutions in Kenya. The Centre for Corporate Governance, (2004) outlined the following reasons as being major contributors to this phenomenon; insider lending and conflict of interest, weaknesses in regulatory and supervisory systems, poor risk management strategies, lack of internal controls and weak corporate governance practices. This followed by the Central Bank of Kenya to outline more bold and elaborate measures to curb these problems and also to strengthen its arm of supervisory role it plays in the industry.

Corporate governance in the banking sector in Kenya largely relates to the responsibility conferred to and discharged by the various entities and persons responsible for and concerned with the prudent management of the financial sector (Central Bank of Kenya, 2006). The corporate governance stakeholders in the banking sector include the board of directors, management, shareholders, Central Bank of Kenya, external auditors and Capital Markets Authority (CCG, 2004). It is believed that good governance generates investor goodwill and confidence. Again, poorly governed firms are expected to be less profitable.

1.2   Statement of the Problem

The subject of corporate governance is not well emphasized in most organization, Kihumba, (2000) this has attracted worldwide attention because of its apparent importance for strategic health of organizations and society in general. Corporate governance should be enriched by expanding the framework of analysis beyond the

conventional criteria to incorporate the norms and values, such considerations can improve our understanding of boardroom dynamics and the characteristics of the decision management and decision control, (Wainaina, 2003).

Locally, there are a few studies in corporate governance though none has focused on commercial Banks. For instance, Jebet (2001) focuses on the listed companies; Macuvi, (2002) focuses on the motor vehicle industry while Mwangi, (2002) focuses on insurance companies. From the published annual financial reports, commercial banks in Kenya recorded unpleasant performance in the early 2000 but there has been significant improvement since 2007 and this study is therefore, is designed to establish the effect if any of corporate governance on financial performance of Commercial Banks in Kenya.

Many other researchers have examined the relationship between variety of governance mechanisms and firm performance. However, the results are mixed. Some examine only the impact of one governance mechanism on performance, while others investigate the influence of several mechanisms together on performance. A number of studies have also been carried out in the area of corporate governance and financial performance in state corporations, in cooperative societies, in companies listed in the Nairobi Stock Exchange in Kenya, examples; Njoka, (2010); Linyiru, (2006); Maina, (2006); Awino, (2011); Muriiti, (2011) and Ooko, (2011).

There is a yawning gap that exists since none of them covers effects of ownership structure on corporate governance and performance specifically in the commercial

banking sector in Kenya. The only study done in Kenya by the Centre for Corporate Governance focused on governance practices in the commercial banking sector in Kenya. More so, the many unpublished work done in Kenya followed suit by focusing corporate governance in general with only one study among them focusing on the relationship between implementation level of Capital Markets Authority guidelines on corporate governance and profitability of companies listed at the Nairobi Stock Exchange (NSE). It was against this background that the researcher found it necessary to carry out a study on ownership structure and corporate governance and its effects on performance in the Kenyan commercial banking sector to bridge the gap that existed.

The research was guided by the following questions:

1. What is the effect of board composition, board independence, shareholders rights, practices and responsibilities on financial performance of Commercial Banks in Kenya?

2. Is there a relationship between transparency, disclosure, polices and financial performance of Commercial Banks in Kenya?

1.3   The Objectives of the Study

The objective of this study was to investigate effects of corporate governance on financial performance of Commercial Banks in Kenya.

1.4   Importance of the Study

The findings of this research project would contribute to improving understanding about corporate governance practices in Kenyan banking, and in what ways the banks can implement good corporate governance that aligns with bank performance. Many Commercial Banks in Kenya will find the study very valuable to their operations and more so a benchmark to decisions to improve on corporate governance in the banking industry.

The policy makers in the banking business will find the study useful as a basis of formulating policies, which can be effectively implemented for better and easier regulation of the banking sector. The government will use the study so as to come up with policies and ways of promoting corporate governance financial institutions in the country.

The empirical results would also provide general indicators of corporate governance useful for both regulator and business people in making policies and decisions as well as in rewarding or punishing the banks that have great or little intention to improve their corporate governance aligning with managers-owners risk-taking behaviour and bank performance. Other researchers and academic community will use this study as a basis for further studies on corporate governance in Kenyan banks.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents the review of various literature related to the area of study. It covers ownership structure, board composition and other issues on corporate governance and its effects on financial performance of commercial banks in Kenya.

2.2 Theoretical Framework

The main theoretical assumption of this research relies on the agency framework. The following discussions explain about corporate governance from the agency framework.

2.2.1 Agency Theory

It is an acknowledged fact that the principal-agent theory is generally considered the starting point for any debate on the issue of corporate governance emanating from the classical thesis on The Modern Corporation and Private Property by Berle and Means (1932). According to this thesis, the fundamental agency problem in modern firms is primarily due to the separation between finance and management. Modern firms are seen to suffer from separation of ownership and control and therefore are run by professional managers (agents) who cannot be held accountable by dispersed shareholders.

Agency theory suggests that there are several mechanisms to reduce the agency problem in the firm. For examples, managerial incentive mechanism compensates managerial efforts to serve the owners' interests; dividend mechanism reduces managerial intention to make an overinvestment decision which will be financed by internal free cash flow;

bonding mechanism reduces managerial moral hazard which potentially occurs when they are not restricted by bond contract and bankruptcy risk. Other owners' efforts to reduce agency cost of equity, potentially created by moral hazard managers, include the intention of owners to choose reputable board of directors; direct intervention by shareholders, the threat of firing, and the threat of takeover(Sanda *et al*., 2005).

2.2.2 Stakeholder Theory

One argument against the strict agency theory is its narrowness, by identifying shareholders as the only interest group of a corporate entity necessitating further exploration. Stakeholder theory has become more prominent because many researchers have recognized that the activities of a corporate entity impact on the external environment requiring accountability of the organization to a wider audience than simply its shareholders. For instance, McDonald and Puxty (1979) proposed that companies are no longer the instrument of shareholders alone but exist within society and, therefore, has responsibilities to that society. One must however point out that large recognition of this fact has rather been a recent phenomenon. Indeed, it has been realized that economic value is created by people who voluntarily come together and cooperate to improve everyone's position (Freeman *et al.,* 2004).

Jenson (2001) critique the Stakeholders theory for assuming a single-valued objective (gains that accrue to a firm's constituencies). The argument of Jensen (2001) suggests that the performance of a firm is not and should not be measured only by gains to its stakeholders. Other key issues such as flow of information from senior management to

lower ranks, inter-personal relations, working environment, etc are all critical issues that should be considered. Some of these other issues provided a platform for other arguments as discussed later. An extension of the theory called an enlightened stakeholder theory was proposed. However, problems relating to empirical testing of the extension have limited its relevance (Sanda *et al*., 2005).

2.3 Corporate governance from Theoretical Perspective

Board of Directors (BODs) has an important role in the management of organizations. Since, BODs are considered to be one of the important governance mechanisms, these groups are increasingly being hold responsible for the organizational performance. For this reason, many studies from diverse fields, including law, economics, finance, sociology, organizational theory and strategic management, focus on BODs (Kiel and Nicholson, 2003). The performance of the organizations is dependent on the realization of the roles of BODs, (Jacob, 2011). These roles are both important and numerous (Finkelstein and Money, 2003).

Johnson, Daily and Ellstrand (1996) suggest that the most emphasized roles of BODs in the literature are control, service and resource dependence roles. The control role entails directors monitoring managers as fiduciaries of stockholders, hiring and firing executives and determining executive compensation. The service role, on the other hand, involves advising executives on administrative and other managerial issues as well as actively initiating and formulating strategy, (Njoka, 2010). Finally, the resource dependence role views the board as facilitating the acquisition of resources critical to firm success.

Hillman and Dalziel (2003) assert that, monitoring as well as resource providing is considered by BODs to be an integral part of their board activities.

Agency theory being the dominant framework (Zahra and Pearce, 1999; Daily, Dalton and Cannella, 2003), researchers employed various theoretical perspectives (i.e. stewardship theory, managerial hegemony theory, stakeholder theory, institutional theory, and resource dependence theory) for the study of BODs. Within the frame of agency theory, it is assumed that BODs control the opportunistic behaviors of the managers; therefore, these groups represent the primary internal control system that fit the interests of shareholders and managers, (Jensen, 1993).

According to Choe and Lee (2003), board composition is very important to effectively monitor the managers and reduce the agency cost. Although the executive directors have specialized skills, expertise and valuable knowledge of the firms' operating policies and day-to-day activities, there is a need for the independent directors to contribute the fresh ideas, independence, objectivity and expertise gained from their own fields (Weir, 1997; Firth et al., 2002). Hence, the agency theory recommends the involvement of independent non-executive directors to monitor any self-interested actions by managers and to minimize agency costs (Le et al. 2006; Williams et al. 2006).

Jensen (1993) mention that boards with more than seven or eight members are unlikely to be effective. They further elaborate that large boards result in less effective coordination, communication, and decision making, and are more likely controlled by the CEO.

Yoshikawa and Phan (2003) also highlight that larger boards tend to be less cohesive and more difficult to coordinate because there might be a large number of potential interactions and conflicts among the group members. In addition, they further state that large boards are often created by CEOs because the large board makes the board members disperse the power in the boardroom and reduce the potential for coordinated action by directors, leaving the CEO as the predominant figure.

The primary focus of re-source dependence theory is the fact that the organizations should interact with its environment as much as it is necessary. Within the frame of resource dependence theory, organizational needs to access environmental resources, emerge as a vital issue for the survival, (Linyiru, 2006). Organizations are considered as an open system that is dependent on other organizations for the provision of important resources (Pfeffer and Salancik, 1998). It is assumed that the success of the organizations is based on their abilities to provide and control the external resources (Aldrich and Pfeffer, 1996). The mechanisms that administer these external dependencies are BODs (Pfeffer and Salancik, 1998).

2.4 Corporate Governance and Bank Performance

Tandelilin et al., (2007) asserts that the central focus in most literature around, discussion analysis in research all over the world on matters to do with corporate governance has been the role of ownership structure as a corporate governance mechanism. Whether the kind of ownership structure matters and what are its implications for corporate governance are areas that raise some concern (Tandelilin et al., 2007). Corporate

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governance can be defined as the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation, (Wheelen and Hunger 2006).

In Kenya, financial reforms have encouraged foreign banks to enter and expand banking operations in the country. Kamau (2009) affirm that foreign banks are more efficient than local banks. She attributes this to the fact that foreign banks concentrate mainly in major towns and target corporate customers, whereas large local banks spread their activities more widely across the country. Foreign banks therefore refrain from retail banking to specialize in corporate products, while large domestic banks are less discriminatory in their business strategy, (Njoka, 2010). These different operational modalities affect efficiency and profitability she notes.

Studies with regard to corporate governance theme have mainly been carried out in developed economies mostly in the United Kingdom and the United States of America with few afore mentioned being done in Africa and specifically Kenya, (Njoka, 2010). However, the concept of governance in Kenya is now increasingly being embraced knowing that it leads to sustainable growth and more so, since Kenya has had a history of poor governance system in the banking industry attributed to weak corporate governance practices, lack of internal controls, weaknesses in regulatory and supervisory systems, insider lending and conflict of interest which led to the collapse of many financial institutions with others going under receivership (Awino, 2011).

2.5 Corporate Governance Framework

Corporate Governance can be described as a system that tries to provide guidelines and principles to the board of directors in order to execute their responsibilities appropriately and to satisfy shareholders eliminating moral hazard problems, (Muriithi, 2011). In this point, it is worth mentioning that a global and unified standard for corporate governance cannot be applied because it could not be responsive to local economies. In the rest Europe Corporate Governance is characterized by institutional diversity. However, the German system prevails in Northern Europe, while the Latin model exists in Southern Europe.

For example in Italy, corporate governance is poor, with banks having a stake in corporate financing but playing a minor role in governance, whereas in France corporate governance is dominated by cross-shareholdings. The fact is that in recent years both models tend to adapt elements from the Anglo-American system. Different European countries handle the issue of corporate governance in different ways. Some of them emphasize on a wider range of stakeholder interests and others emphasize on the ownership rights of shareholders, (Clarke Thomas, 2007).

Developing countries are now increasingly embracing the concept knowing it leads to sustainable growth. Indeed, corporate governance in Kenya is now gaining some level of recognition with very little work in the area even in the well-regulated institutions and sectors. Several studies have been done to establish relationship between governance structure and firm's performance. One argument is that a strong corporate governance

structure, could lead to a high performance (Sanda et al, 2005). It will help to promote a firm's performance and protect stake holder's interests. The corporate governance issues are more elaborated below:

2.5.1 The Board Size

The Board of directors of an organization is a key mechanism to monitor manager's behavior and to advise them. The largely shared wisdom regarding the optimal board size is that the higher the number of directors sitting on the board the less is performance. This leans on the idea that communication, coordination of tasks, and decision –making effectiveness among a large group of people is harder and costlier than it is in smaller groups, (Belkhir, 2006).

Limiting board size to a particular level is widely believed to improve the performance of the firm at all levels. Benefits arising from increased monitoring by larger boards are outweighed by poorer communication and cumbersome decision –making. Empirical studies on board size seem to provide the same conclusion: A big board is likely to be less effective in substantive discussions of major issues among themselves in monitoring management. Large boards are less effective and are easier for CEO to control (Lipton and Lorsch, 1992). In this case, Board size plays a major role on the performance of every prospering organization.

2.5.2 Board composition

Globalization and liberalization of financial markets, corporate governance scandals and increasing demands of stakeholders for accountability and transparency of organizations,

brought the roles and tasks of board of directors (BODs) to the center of corporate governance debate (Ingley and Van der Walt, 2005). BODs have various and important roles (Finkelstein and Money, 2003). According to Zahra and Pearce (1989), the main roles of BODs are control, service and strategy. Realization of these roles mainly depends on the characteristics of boards, which affect the performance of organizations, (Johnson et al, 1996).

In this study, focusing on these discussions, it is aimed to investigate the effect of board composition, measured in terms of insider director, outsider director and affiliated director presentation, on organizational performance of firms listed in NSE. BODs are in general the main decision-making body of organizations listed in NSE and they are primarily responsible for the fate of their organizations, therefore the study of the effect of these groups on organizational performance exists as an important research topic.

2.5.3 Ownership Structure and Type of Bank Ownership

Ownership structure is the identity of company ownership and an important element of corporate governance which is potentially important. Ownership structure consists of two type, dispersed ownership to outside investors and concentrated ownership, (Surya et..al, 2005). Ownership concentration in some families or business group cause a big control to majority shareholder, which eventually a different treatment between shareholders emerge and the one who will be harm is the minority shareholders. Ownership concentration is determined by the number of share that is held by three biggest

shareholders and counted with Herfindahl index which is the square amount of share proportion (in percent), (Firth et..al, 2006).

Investor protection is high when the management ownership is high because outside investors expect the manager with their share ownership significantly will act in the best interest of all the shareholders to minimize the negative impact from unanticipated crisis of their share, (Leung et..al, 2007). Durnec and Kim (2003) claim that the bigger the ownership that owned by the controller shareholders and it will improve the quality and performance of a firm. Juliana (2006), proves that a high ownership concentration can give a trustable commitment from the controller owner with a purpose to build reputation and not to misuse the interest of minority shareholders. In this regard, ownership concentration factor is one of the determinants in the performance of banks as business institutions.

2.5.4 Transparency and Disclosure

Transparency is integral to corporate governance, higher transparency reduces the information asymmetry between a firm's management and financial stakeholder's (equity and bondholders), mitigating the agency problem in corporate governance (Sandeep et al,2002). The concept of Bank transparency is broad in scope it refers to the quality and quantity of public information on a bank's risk profile and to the timing of its disclosure, including the banks past and current decisions and actions as well as its plans for the future. The transparency of the banking sector as a whole also includes public

information on bank regulations and on safety net operations of the central bank (Enoch et al, 1997).

2.5.4 Insider shareholding and firm value

The first argument to address the problem of agency concerns the use of insider shareholding. Several researchers (DeAngelo and DeAngelo, 1985; McConnell and Servaes, 1990; Loderer and Martin, 1997; Nor et al., 1999; Yeboah-Duah, 1993) have undertaken research on this aspect, reporting very conflicting results. In particular, McConnell and Servaes (1990) find a significant curvilinear relationship between insider ownership and firm performance. While Loderer and Martin (1997) find no significant relationship, Nor et al. (1999) reported a non-linear relationship, drawing conclusions contrary to those of Yeboah-Duah (1993).

2.5.5 The Role of Debt

Finally, debt owed to large creditors such as banks is also believed to be a useful tool for reducing the agency problem. Large creditors, like large stakeholders, also have interest in seeing that managers take performance-improving measures. Empirical evidence seems to be in support of this assertion. Shleifer and Vishny (1997) in a review article, cite the works of Kaplan and Minton (1994), who found higher incidence of management turnover in Japan in response to poor performance in companies that have a principal banking relationship relative to companies that do not. Another form of agency problem, known as debt agency, arises when there is a conflict of interests between stockholders and debt holders.

2.6 Financial Performance and financial institutions

Financial soundness is a situation where depositor's funds are safe in a stable banking system. The financial soundness of a financial institution may be strong or unsatisfactory varying from one bank to another (BOU, 2002). External factors such as deregulation; lack of information among bank customers; homogeneity of the bank business, connections among banks do cause bank failure. Some useful measures of financial performance which is the alternative term as financial soundness are coined into what is referred to as CAMEL as elaborated below:

Capital Adequacy: This ultimately determines how well financial institutions can cope with shocks to their balance sheets. The bank monitors the adequacy of its capital using ratios established by The Bank for International Settlements. Capital adequacy in commercial banks is measured in relation to the relative risk weights assigned to the different category of assets held both on and off the balance sheet items (Awino, 2010).

Asset Quality: The solvency of financial institutions typically is at risk when their assets become impaired, so it is important to monitor indicators of the quality of their assets in terms of overexposure to specific risks trends in non- performing loans, and the health and profitability of bank borrowers especially the corporate sector. Credit risk is inherent in lending, which is the major banking business. It arises when a borrower defaults on the loan repayment agreement, (Bank of Uganda, 2002).

Earnings: The continued viability of a bank depends on its ability to earn an adequate return on its assets and capital. Good earnings performance enables a bank to fund its expansion, remain competitive in the market and replenish and /or increase its capital (Juliana, 2006).

Liquidity: Initially solvent financial institutions may be driven toward closure by poor management of short-term liquidity. Indicators should cover funding sources and capture large maturity mismatches. An unmatched position potentially enhances profitability but also increases the risk of losses (Linyiru, 2006).

2.6.1 Measurements of Financial Performance variables

It is widely acclaimed that good corporate governance enhances a firm's performance (Brickley *et al*, 1994; Jenson, 2001; Sanda *et al*, 2005; Freeman *et al*, 2004). In spite of the generally accepted notion that effective corporate governance enhances firm performance, other studies have reported negative relationship between corporate governance and firm performance (Bathala and Rao, 1995) or have not found any relationship (Singh and Davidson, 2003; Young, 2003). Several explanations have been given to account for these apparent inconsistencies. Some have argued that the problem lies in the use of either publicly available data or survey data as these sources are generally restricted in scope. It has also been pointed out that the nature of performance measures (i.e. restrictive use of accounting based measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) or restrictive use of

market based measures (such as market value of equities) could also contribute to this inconsistency (Gani and Jermias, 2006).

Furthermore, it has been argued that the "theoretical and empirical literature in corporate governance considers the relationship between corporate performance and ownership or structure of boards of directors mostly using only two of these variables at a time" (Krivogorsky, 2006). For instance, Hermalin and Weisbach (1991) and McAvoy *et al.* (1983) studied the correlation between board composition and performance, whiles Hermalin and Weisbach (1991), Himmelberg *et al.* (1999), and Demsetz and Villalonga (2001) studied the relationship between managerial ownership and firm performance.

To address some of the aforementioned problems, it is recommended that a look at corporate governance and its correlation with firm performance should take a multivariate approach. The present study adds to the literature by employing both market based and accounting based performance measures such as return on assets and Tobin's q and test the relationship between them and selected governance variables. In addition to board characteristics, the researcher will include board activity intensity as well as audit committee practices and characteristics and institutional shareholding as an extended arm of governance. The researcher will combine survey and publicly available governance data to broaden the scope of governance variables.

2.7 Empirical studies on effects of Corporate Governance on Bank performance

Most of the studies on the link between corporate governance and firm performance confirm causality (Abor & Adjasi, 2007). However, the evidence indicates between a strong and very weak relationship. Black (2001), for instance found a strong correlation between corporate governance and firm performance, as represented by stock valuation. Choi and Hasan (2005) examined the effect of ownership and corporate governance on Korean bank's performance during 1998 – 2002 by using a simple ordinary least squared model reporting that the existence of one foreign director on the board improves bank performance significantly, but multiple foreign directors on the board do not improve bank's performance.

In the same way, the empirical evidence is supportive of the hypothesis that large shareholders are active monitors in companies, and that direct shareholder monitoring helps boost the overall profitability of firms. This result is also borne out by studies of managerial turnover. For example, Franks and Mayer (1994) find a larger turnover of directors when large shareholders are present, again indicating that large shareholders are active monitors. It seems, therefore, that the beneficial effects of direct monitoring, and a better match between cash flow and control rights, more than outweigh the costs of low diversification opportunities or rent extraction by majority owners.

In addition, Roe (1994) states that the low ownership concentration in the US compared to other countries may be the result of policies initiated by controlling managers that discourage large holdings e.g. anti-takeover devices. This implies that for the US at least,

that managers are strong relative to shareholders and that management entrenchment is a serious problem. Therefore, policy makers in outsider systems like the US and UK should pay particular attention to the negative effects of mechanisms that are often employed by management that inhibit the market for corporate control.

In surveys of corporate governance, Shleifer and Vishny (1997) and Gugler (1999) find that the empirical evidence suggests that control is valued, which would not be the case if controlling blockholders or large shareholders received the same benefits as other investors. For example, Barclay and Holderness (1992) find that in the US, large blocks of equity trade at a substantial premium to the post-trade price of minority shares, and that on average these blocks trade at a 20% premium. This supports the hypothesis that purchasers of the block of shares that may have a controlling influence receive private benefits. Other studies, taking a different approach, also support this hypothesis by comparing the price of shares that have identical dividend rights but differential voting rights. For the US, Zingales (1995) find that shares with superior voting rights trade at a premium, but that this premium is small.

Therefore, while direct shareholder monitoring is a good substitute for compensation incentives, the evidence suggest that the board and monitoring by institutional investors, on the other hand, are relatively weak monitoring devices and not a good substitute for direct monitoring. Love and Rachinsky (2008) in their paper investigate the connection between ownership, corporate governance and operating performance in the banking sector for the period 2003 – 2006. Their sample consists of 107 Russian banks and 50

Ukrainian banks. Regression results showed some significant but economically unimportant relationship between corporate governance and operating performance.

Tandelilin et al. (2007) examined the correlation among corporate governance, risk management and bank performance using a sample of 51 Indonesian banks for the period 1999 – 2004. For the empirical study they used a Triangle Gap Model with primary data analysis and secondary data analysis. This study revealed that bank ownership affects both the relationship of corporate governance and bank performance and corporate governance and risk management. It is worth mentioning that the model used in this study found no linear effect of corporate governance on bank performance.

Rose (2007) used a sample of all Danish firms listed at the Copenhagen Stock Exchange for the period 1998 – 2001 excluding banks and insurance companies in order to examine whether ownership affects firm's performance, measured by Tobin's q. The cross sectional regression analysis showed that increased ownership by institutional investors did not have an impact firm's performance. However decomposing the results, it was evident that ownership by banks had a positive significant impact on performance. Barako and Tower (2007) investigated the association between ownership structure and bank performance in Kenya. Their empirical analysis included all financial institutions operating in Kenya and ran a multivariate regression with variables referring to ownership, bank size and ROA.

The results provided a strong support that ownership structure influence bank performance. Specifically, board ownership is significantly and negatively associated with performance, institutional shareholders have no significant influence on performance and foreign ownership has a significant positive impact of bank's performance. Nam et al., (2002) found that corporate governance should lead to better performance since managers are better supervised and agency costs are decreased. Poor corporate governance on the other hand is a fertile ground for corruption and poor financial performance. Brown et al (2003) found that firms with weaker corporate governance perform poorly compared to those with stronger corporate governance in terms of stock returns, profitability, riskness and dividend payments. Findings from past studies on the selected corporate governance variables in the literature are as follows:

a) Reliability of financial reporting

The accuracy and reliability of the financial reports issued by management affects the perception of the firm by all other stakeholders and prospective investors. In spite of the experience at NSE, the financial reporting of publicly quoted financial firms are generally perceived to be more transparent and credible, because they are usually subjected to stiffer or more rigorous scrutiny, than what obtains in private financial firms. And, this therefore makes the financial reporting component of corporate governance even more difficult to assure in privately held firms. Audit committees and external auditors are the main instruments available for ensuring this corporate governance variable. There is however scant evidence of empirical research findings around this particular variable.

b) Existence of code of corporate governance

The growing concern about the need to institutionalize corporate governance mechanisms in the financial institutions has elicited the issuance of codes of governance by different regulatory agencies and voluntary industry associations. However, clear evidence of the exact extent to which Kenyan commercial banks have adopted these codes or developed their own company-specific governance procedures is still unknown largely because of dearth of readily available data.

c.) Audit committee

Although results of Klein (2002) and Anderson, Mansi and Reeb (2004) showed a strong association between audit committee and commercial banks' financial performance, Kajola (2008) found no significant relationship between both variables. This lack of consensus presents scope for deeper research on the impact of this corporate governance variable.

d.)   Board size

There is a convergence of agreement on the argument that board size is associated with bank financial performance. However, conflicting results emerge on whether it is a large, rather than a small board, that is more effective. For instance, while Yermack (1996) had found that Tobin's Q declines with board size, and this finding was corroborated by those of Mak and Kusnadi (2005) and Sanda, Mikailu and Garba (2005) which showed that small boards were more positively associated with high firm performance. However,

results of the study of Kyereboah-Coleman (2007) rather indicated that large boards enhanced shareholders' wealth more positively than smaller ones.

e.) Separation of office of board chair and CEO

Separation of office of board chair from that of CEO generally seeks to reduce agency costs for a firm. Kajola (2008) found a positive and statistically significant relationship between performance and separation of the office of board chair and CEO. Yermack (1996) equally found that firms are more valuable when different persons occupy the offices of board chair and CEO. Kyereboah-Coleman (2007) proved that large and independent boards enhance firm value, and the fusion of the two offices negatively affects a firm's performance, as the firm has less access to debt finance. The results of the study of Klein (2002) suggest that boards that are structured to be more independent of the CEO are more effective in monitoring the corporate financial accounting process and therefore more valuable. Fosberg (2004) found that firms that separated the functions of board chair and CEO had smaller debt ratios (financial debt/equity capital).

2.8 Conclusion

In summary, it is not feasible to accept one general conclusion for the relationship between firm performance and corporate governance. However, empirical results show that generally ownership structure affects significantly corporate performance, (Njoka, 2010). More specifically, ownership concentration does not have any impact on firm's performance, in addition to independent ownership, which has a negative impact on

profitability and as a result on performance. Moreover, it is stated that weak corporate governance leads to poor corporate performance, (Muriithi, 2011).

Generally, literature on corporate governance comprises attributes such as financial transparency, disclosure and trust among others and it is revealed that financial transparency and disclosure enhance trust between the stakeholders and organizations, (Jacob, 2011) like commercial banks. Capital Adequacy, Earnings and Liquidity are the key dimensions of measuring financial performance in Commercial Banks. In summary, this literature forms an underpinning for the establishment of the association between corporate governance and financial performance.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research design, the description of the study population, the sampling procedures, and data collection procedures, data collection instrument, data analysis and the limitation of the study.

3.2 Research Design

In order to look at the ownership structure and corporate governance and its effects on performance in the Kenyan commercial banks, this research study used cross sectional and analytical research designs. This research design was used to collect a snap shot of data and analysis of the relationships between study variables. The design was more appropriate as it enabled respondents to give their relevant information on the issue of interest to the study, (Cooper & Schindler, 2003).

3.3 Population

Target population in statistics is the specific population about which information is desired. According to Mugenda & Mugenda (2003), a population is a well-defined or set of people, services, elements, and events, group of things or households that are being investigated. The study population was all the 44 commercial banks in Kenya indicated in appendix.

3.4 Sample

Due to the variability of characteristics among items in the population, the researchers applied scientific sample designs in the sample selection process to reduce the risk of a distorted view of the population, and made inferences about the population based on the information from the sample survey data. According to Mugenda (2003), a sample ratio of 0.3 was used to obtain sample representation of all respondents. In this case, thirteen (13) commercial banks were subjected to the study. Only the sampled population was subjected to the data gathering exercise to provide the necessary information for the study.

3.5 Sources of Data

The two sources of data are primary and secondary data. Primary data were obtained by administering questionnaires to the sampled commercial banks. Secondary source were provided information and data from the published annual reports and company sources spanning five years. In this study, questionnaires and abstraction methods were used in collecting data. Questionnaire was used to collect primary data directly from the respondent. It consisted of questions on Corporate Governance, board roles, board effectiveness, size and contingency. Abstraction method was used to collect secondary data from financial reports and statements provided by the sampled banks. In order to increase reliability of the findings, a combination of data from annual financial reports and questionnaires were used.

3.5.1 Reliability and Validity tests

Prior to visiting the company for data collection, the researcher will have to obtain a letter from the authorities to permit him proceed in obtaining the data. The purpose of the letter is to ensure trustworthiness by the respondent and therefore able to provide quality and reliable data. On the other hand the content validity and reliability was assured by ensuring that each question in the questionnaire and interview schedule is valid and correctly structured for easy understanding. Moreover, the secondary data to be reviewed must be recent and up to date as well as containing relevant contents.

To ensure reliability, the researcher pre-tested the questionnaire using two commercial banks. The purpose of the pilot study was to enable the researcher to improve on the reliability of the data collecting instruments and to familiarize with their administration. According to Masibo (2005), pre-testing provides a check on the feasibility of the proposed procedure for coding data and shows up flaws and ambiguities in the instruments of data collection. It also yielded suggestions for improvement of data collecting tools. The test-retest technique of measuring reliability was used in the case. This involved administering the questionnaire to the two pilot CEOs twice with a time lapse of one week and then computing the correlation coefficient (r) for the two tests.

On the other hand the content validity of the two instruments of data collection was assured by ensuring that each of the items in the questionnaire and interview schedule addressed specific contents and objectives of the study. Moreover, the instruments were given to two banking experts who assessed the concepts which the instruments tried to

measure. The end result was that the instruments were appropriate in terms of content validity. The validity and reliability of the tools for data collection were eventually ascertained, and used to collect data from the sampled respondents.

3.6 Data analysis

The independent variable which is corporate governance was measured in terms of board structure / size and decision making. Board roles were measured in terms of monitoring and control, access to resources, strategy and advice and counsel. Board effectiveness was measured in terms of committees, risk management, delegation, skills and knowledge. Financial performance as dependent variable was measured in terms of the revenue collection performance ratio of actual revenue over budgeted revenue, expenditure performance ratio of actual expenditure over budgeted expenditure.

Value for money was measured as a ratio of actual revenue over actual expenditure (efficiency). Data analysis was carried out by use of narrative analysis strategy, by gauging the extent to which given information provides insights about the issues of corporate governance and its effect on financial performance of commercial Banks. Some statistical software was also used in analysis of quantitative data. The results from the annual financial reports and other documentations were presented in tables, and in form of charts, graphs and narrative statements.

3.7 Variables for Bank Financial Performance

Bank performance represents the objective of shareholder's interest. This study employed a single variable for bank performance relevant to return on shareholder's investment, called ROE.

Return on equity reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. It is calculated through the following formula:

$$\text{Return on Equity} = \frac{Net\ Income}{Shareholder's\ Equity}$$

A business that has a high return on equity is more likely to be one that is capable of generating cash internally. For the most part, the higher a company's return on equity compared to its industry, the better.

3.8 Bank Performance equation

Separation between ownership and management has led to the creation of problems within the institution as a result of conflicting interests of owners and managers leading to the need to search for those means which ensure consensus and ending the conflict. Due to financial crises, especially during the past few years, interest has grown in what is known as corporate governance as a contributor to ending this problem through the adoption of governance mechanism ensuring that managers act to serve shareholders' interests to improve performance and maximize shareholders' wealth, (Aljifri & Moustafa, 2007).

The performance equation for the study was formulated as follows:

There was a statistically indicative effect for bank corporate governance (i.e. corporate governance practices, Shareholders rights and responsibilities, Disclosure policies and practices, corporate governance policies in ROE as indicator of bank financial performance. This was illustrated by the equation below:

ROE= $\beta_0 + \beta_1$ CGPR + β_2 SRR + β_3 DPP + β_4CGPO + ε

Where:

CGPR: Corporate Governance Practices

SRR: Shareholders Rights and Responsibility

DPP: Disclosure Policies and Practices

CGPO: Corporate governance policies

ε: Standard Errors

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

This chapter presents the analysis and the results of the study. The analysis was based on the data collected by use of questionnaires administered to CEOs of sampled commercial banks and review of financial reports. The study targeted 13 CEOs of which a good number responded indicating a 69.2% response rate.

4.2 Corporate Governance factors that affect financial performance in Commercial Banks

The objective of this study was to investigate effects of corporate governance on financial performance of Commercial Banks in Kenya. Corporate governance factors (which form independent variables) consisted of; corporate governance practices, policies, disclosure of practices and policies, shareholder rights and responsibilities. The independent variable was financial performance of commercial banks.

4.2.1 Corporate governance Practices

The study sought to find out the level of agreement on various issues of corporate governance practices in commercial banks. From the findings below, it was noted that commercial banks do practice corporate governance. In general the was a mean of 1.81 and Std. Dev 0.66 on this variable and this means that there was agreement that corporate practices have been adopted by commercial banks in Kenya. In addition, there was an

assertion that corporate governance policies, standards and regulations have been adopted in commercial banks in Kenya; M=1.6, SD=0.7.

More so, it was found that the disclosure policies and practices are always adhered by many commercial banks. Generally, factors attributed to disclosure policies and practices in commercial banks in Kenya were rated high and had a mean of 1.6 and Std. Dev of 0.8. On Shareholder rights and responsibility, it was noted that, shareholders are encouraged to attend and vote during the annual general meeting, M=1.4, SD=0.5; and that they are provided high reliable and accurate information M=1.4, SD=0.5. It was also agreed that shareholders are aware of their rights and responsibilities, M=1.4, SD=0.5. Generally, there was a mean of 1.6 and Std. dev of 0.6 on the shareholder rights and responsibilities variable as shown below.

Figure 4.1 – Corporate governance factors
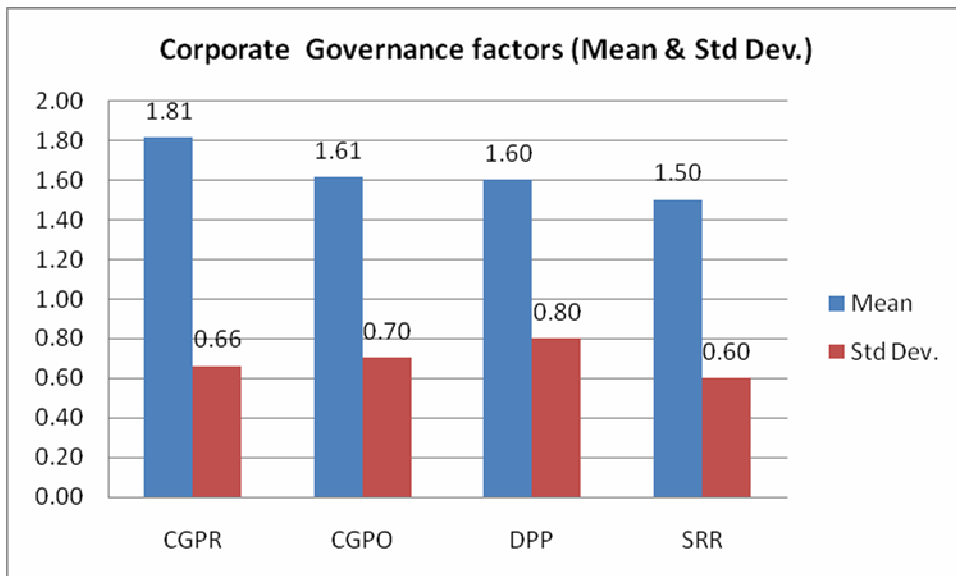
Scale: *1- Strongly Agree (SD), 2 - Agree (D), 3 - Uncertain (U), 4 - Disagree (A), 5 - Strongly Disagree (SA)*

4.3 Performance of commercial Banks in Kenya

Bank performance is the bank profitability and productivity in banking (Jeon and Miller 2006). In addition, performance may also refer to the development of the share price, profitability or the present valuation of a company. Bank Performance represents profitability of bank in banking sector. Profitability is measured by return on equity, after tax profits divided by the book value of equity (Brigham and Ehrhardt 2005). In this case, RoE and Mean of respondent's rating on performance has been adopted as a measure of financial performance.

ROE and ROCE

ROE is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. ROE is expressed as a percentage and calculated as:

$$\textbf{Return on Equity} = \frac{\textbf{Net Income}}{\textbf{Shareholder's equity}}$$

Net income is for the full fiscal year (before dividends paid to common stock holders but after dividends to preferred stock.) Shareholder's equity does not include preferred shares. ROCE is a ratio that indicates the efficiency and profitability of a company's capital investments. It establishes the relationship between the profit and the capital employed. It

indicates the percentage of return on capital employed in the business and it can be used

to show the overall profitability and efficiency of the business.

$$ROCE\,(\%) = \frac{Operating\,profit}{Capital\,employed} \times 100$$

For the sake of this study, data for both measurements were acquired as indicated in the

chart below. Only ROE was used as performance measurement and implemented in the

regression equation below. This is because ROE demonstrates a company's ability to

generate profits from shareholders' equity (also known as net assets or assets minus

liabilities). In other words, ROE shows how well a company uses investment funds to

generate growth and therefore, stands to measure bank's performance.

Figure 4.3 – ROE and ROCE
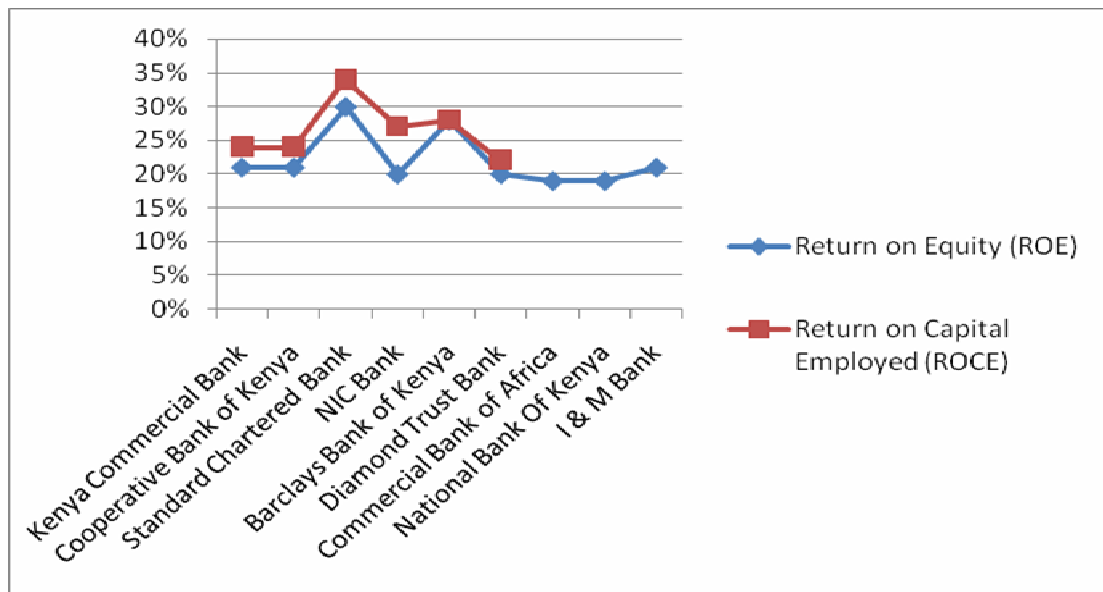
Descriptive Statistics (Mean & Std. Dev.)

	N	Minimum	Maximum	Mean	Std. Deviation

	N	Minimum	Maximum	Mean	Std. Deviation
Measure of Financial Performance (ROE)	13	4.00	7.00	2.1333	.91548
Valid N (listwise)	13				

Source: Financial reports (2006 -2011)

The above figure shows descriptive statistics (mean and standard deviation) for ROE as performance measure in commercial banks.

4.6 Correlation of financial performance indicator and corporate governance factors

The first step was to construct correlation matrix for various possible combinations of dependent and independent variables. The outcome of this exercise was the understated correlation matrix as shown below.

Table 4.8 - Correlation of financial performance and corporate governance factors

Correlation of financial performance and Corporate governance factors		Measure of Financial Performance (ROE)	CGPR	CGPO	DPP	SRR
Measure of Financial Performance (ROE)	Pearson Correlation	1	.647	.629	.987[*]	.687[*]
	Sig. (2-tailed)		.238	.256	.012	.013
	N	15	9	9	9	9
CGPR	Pearson Correlation	.647	1	.848	.644	.133
	Sig. (2-tailed)	.238		.069	.241	.733
	N	9	95	9	9	9
CGPO	Pearson Correlation	.629	.848	1	.465	.886
	Sig. (2-tailed)	.256	.069		.431	.114
	N	5	9	9	5	9
DPP	Pearson Correlation	.987[*]	.644	.465	1	.533
	Sig. (2-tailed)	.012	.241	.431		.218
	N	9	9	9	9	7

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SRR	Pearson Correlation	.687[*]	.526	.886	.533	1
	Sig. (2-tailed)	.013	.225	.114	.218	
	N	6	9	9	7	9

*. Correlation is significant at the 0.05 level (2-tailed).

Source: Field Data 2012

The correlation matrix highlighted that there is significant correlation between independent variables and the dependent variable. DPP and SRR showed a strong and significant relationship with financial performance, (Pearson's r = 0.987, Sig. = 0.012) and (Pearson's r = 0.687, Sig. = 0.013) respectively. It is apparent from the correlation matrix that there is strong correlation between other variables,(CGPR and CGPO) but insignificantly. To get a better picture of the relationship among the key variables regression analysis was also performed.

4.7 Regression model (Test of variables)

A multivariate regression model was used to determine the relative importance of each of the four variables with respect to financial performance. This led to the adoption of a set of indicators which are indicative of the bank's current status and the extent of its ability to achieve the desired objectives. The indicator ROE has been adopted.

The multiple regression model for the study was:

ROE= $\beta_0 + \beta_1$ CGPR + β_2 SRR + β_3 DPP+ β_4CGPO + ϵ

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Where:

      CGPR: Corporate Governance Practices

      SRR: Shareholders Rights and Responsibility

      DPP: Disclosure Policies and Practices

      CGPO: Corporate governance policies

      Ɛ: Standard Errors

4.7.1 Model Summary

Table 4.4 (a.) below, shows R which is the correlation between the observed and predicted values of the dependent variable to be 0.459, while R square which is the proportion of variation in the dependent variable is 0.235. The adjusted R square is 0.224 showing a relationship between the observed and predicted values of the dependent variable. This indicates that CGPR, CGPO, DPP and SRR accounts for 22.4 % of the financial performance of commercial banks as indicated in table below.

Table 4.9 (a.) – Regression analysis (Model summary)

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.459[a]	.235	.224	.28358

a. Predictors: (Constant), CGPR, CGPO, DPP, SRR

Source: Field Data 2012

4.5.2 ANOVA

ANOVA table shows results of analysis of variance, sum of squares, degree of freedom (df), mean square, regression and residual values obtained from regression analysis. From table 4.9 (b.) below, the mean square which is the sum of squares divided by the degrees of freedom was 9.081. The F static which is regression mean square divided by the residual mean was 38.83. Degree of freedom df, was 4.00. Statistically, the overall relationship was very significant with significant value, P value = 0.010, (P < 0.05) as shown below

Table 4.9 (b.) – Regression analysis (ANOVA)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	36.325	4	9.081	38.835	.010[a]
	Residual	47.237	202	.234		
	Total	83.562	206			

a. Predictors: (Constant), CGPR, CGPO, DPP, SRR

b. Dependent Variable: Financial performance (ROE)

Source: Field Data 2012

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.5.3 Regression Coefficients

Coefficient of independent variables (CGPR, CGPO, DPP and SRR) and the dependent variable (Financial performance - ROE) are presented in table 4.9 (c.) below. The significance column, showed only two predictors (CGPO and SRR) were significant since its significant value were less than 0.05, i.e. P value = 0.000 both of them. However, the other two predictors (CGPR and DPP) were indicated not significant since their significance values were greater than 0.05, i.e. P value = 0.765 for CGPR and P value = 0.811 for DPP as shown in table below.

Interpreting the values of beta (β) coefficients, it means that holding all other independent variables constant, every unit change on CGPR shall increase performance by 0.016, change in CGPO will impact on performance by 0.421 and SRR will change it by 0.241. However, change in DPP shall affect financial performance negatively by -0.014. Therefore, CGPR, CGPO and SRR variables were the positive predictors bank's financial performance .

Table 4.9 (c.) – Regression analysis (Coefficients)

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.857	.141		6.058	.000		
	CGPR	.016	.053	.022	.299	.765	.505	1.980
	CGPO	.421	.083	.429	5.079	.000	.393	2.548
	DPP	-.014	.059	-.015	-.239	.811	.717	1.395
	SRR	.241	.053	.302	4.572	.000	.641	1.560

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.857	.141		6.058	.000		
	CGPR	.016	.053	.022	.299	.765	.505	1.980
	CGPO	.421	.083	.429	5.079	.000	.393	2.548
	DPP	-.014	.059	-.015	-.239	.811	.717	1.395
	SRR	.241	.053	.302	4.572	.000	.641	1.560

 a. Dependent Variable: Financial performance (ROE)

Source: Field Data 2012

In addition, table 4.4 (c.) above also show multicollinearity test. The purpose of this test was to know whether any correlation among independent variables was found or not. A good regression model should be free from correlation between variables. If those variables are not ortogonal. Ortogonal variable is independent variable which has zero correlation with other independent variables.

To detect multicollinearity could be seen from correlation matrix among independent variables on the value of variance inflation factor (VIF). If VIF value is below 10 and Tolerance value is above 0.1, it means there is no multicollinearity among independent variables. From table above, the Tolerance values and VIF values for each variable were; 0.505 and 1.980 for CGPR, 0.393 and 2.548 for CGPO, 0.717 and 1.395 for DPP and finally 0.641 and 1.560 for SRR variables. It means that VIF value < 10 and tolerance value > 0.1, so multicolinearity does not exist.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of findings to the study, and in the process, draws conclusions based on the finding of the study. The chapter subsequently, makes recommendations arising from the conclusions of the study. Finally the chapter makes suggestions for further research in connection with certain specific areas of this study.

5.2 Summary of Findings

The purpose of the study was to establish the effects of corporate governance factors on financial performance of commercial banks. In summary, the following are findings:

From the findings majorioty (55.6%) of the respondets were male while the rest, minority (44.4%) were female. Majority of them have specialized in finance, few have specialized in internal audit and other fields. In regard to corporate practices, it was found that most commercial banks have implemented sound corporate governance practices. They have strong internal systems and the internal auditors report to the audit committee. This is important in ensuring strong internal controls, effectiveness and efficiency system practices.

It was also clear that commercial banks have policies on corporate governance. It was agreed that BoDs have regular meeting. There are also various committees (e.g compliance, risk, insurance and compensation committees) to run various business affairs in the bank. It was also found that banks have clear procedures and specifications

covering issues as; rights of shareholders, duties of the Directors, rules and disclosure issues.

We find that there is a significant relationship between transparency disclosure and financial performance of Commercial banks. This can be attributed to the fact that the bank's business relies heavily on trust that clients have in the management of the bank and the more transparent they are and the more the disclosures the more trust they earn from their clients who translates into growth and better financial performance.

Commercial banks has had improved financial performance over the last three years as shown from some financial ratios obtained from annual accounts we cannot say all this is attributable to good corporate governance. There are many other factors that contribute to financial performance of Commercial banks.

Shareholder's rights affect the quality of corporate governance significantly which in turn affect financial performance of Commercial banks. Equitable treatment of all shareholders, including minority should be upheld. All shareholders should have the opportunity to obtain effective redress for violation of their rights. Majority of shareholders are not aware of their role of holding the directors accountable.

From the regression analysis, it was found out that, CGPR, CGPO, DPP and SRR accounts for 23.5% of the financial performance of commercial banks. More so, two predictors (CGPO and SRR) were significant since their significant values were less than 0.05, i.e. P value = 0.000 both of them. However, the other two predictors (CGPR and DPP) were indicated not significant since their significance values were greater than 0.05,

i.e. P value = 0.765 for CGPR and P value = 0.811 for DPP. Multicollinearity test proved no multicolinearity on the independent variables.

Corporate governance is most likely to play an important role in the issue of bank stability and bank's ability to provide liquidity in difficult market conditions. The impact on stability may turn out to be the most important benefit of good corporate governance for banks. This would be an important question to address in further research.

5.3 Conclusion

The relevance of corporate governance cannot be over-emphasized since it constitutes the organizational climate for the internal activities of a company. Corporate governance brings new outlook and enhances a firm's corporate competitiveness. The study examined the effect of corporate governance on the performance of commercial banks in Kenya by using ROE based performance measures. Indeed, corporate governance plays a vital role in the success and prosperity of the banks and other business firms. The regression results show further that the direction and the extent of firm's performance is dependent on the predictors being examined. Results show that large corporate practices, policies and rights of shareholders enhance corporate performance and that when such factors are capitalized, it enhances firm value.

The results of the study may be taken as a sign that good governance structure is important in the young and immature financial institutions as it has an effect on the institution performance. The observations of the study do not only aim at fine-tuning governance in Commercial banks in terms of policy direction, but equally important to

ensure collapse of Commercial banks as a result of governance is forestalled so as not to dent the critical process of poverty reduction and development.

5.4 Recommendations

For banks to have sustainable growth and stability they should embrace best practices of corporate governance which will ensure that shareholders wealth is looked after in the best way possible, that adequate risk management measures are put in place and that standards are not only in writing but that they are practiced on a day to day basis.

The findings provide shareholders with information that they have an important role to force banks' management to implement good corporate governance. In order to control the managers to implement good corporate governance, they should establish certain control mechanisms. The study informs government that it has to be concerned with good corporate governance practices in banks since they are unique from other sector.

The central bank of Kenya has to encourage banks to implement corporate governance practices through enacting rules and regulations. Corporate governance practices will ensure that banks maintain the level of risk they can handle and give depositors sufficiently safe level of their savings and investments.

We recommend that banks formally adopt and implement OECD Principles of Corporate Governance within their policies and procedures, and report on their compliance in their annual reports.

Banks should develop corporate governance policies for the appointment of independent board members, establish and maintain better relations with their stakeholders, and establish the unitary model of board system, in accordance with existing legal provisions.

Banks should develop training programmes for their managerial personnel, as well as for board members, aiming at improving and advancing their corporate governance practices in the light of OECD principles.

The Institute of Certified Public Secretaries of Kenya should come up with awards for banks that practice best practices of good corporate governance to encourage banks enhance their corporate governance.

5.5 Limitation of the study

Although this research was well prepared, I am still aware of its limitations and shortcomings. First of all, the study population was thirteen banks drawn from the entire population, and might not represent the majority of the financial institutions.

In addition, since the assessment of the pretest and post test was conducted by the author himself, it is unavoidable that in this study, certain degree of subjectivity can be found. In fact, it would have been sort of objective if it had been decided by two or three examiners.

5.6 Suggestions for Future Research

The debate on corporate governance continues both in academic circles and popular press, and both in Kenya and international levels shows that this field is very important

and needs urgent attention. The current literature addresses a range of issues relating to corporate governance practices and firm performance, although this study contributes to the body of literature on various dimensions, the results are not conclusive. Observations covering a period of five years and in one country may not be representative, and the results may not be generally applicable to developing countries.

The sample in this study was chosen according to availability of data and the choice of statistical analysis was determined by the period and MFI covered. It would therefore, be desirable to extend the present study by complementing it with other studies using other methods and including comparative data. The inclusion of other corporate governance and performance variables such social performance indicators as would also merit further considerations. Also the results must also be carefully handled since many specific factors can impact MFI's working process. More research on practices of board is needed to assess the effects on MFIs performance in Africa and beyond.

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APPENDICES

APPENDIX A: INTRODUCTION LETTER

Dear Respondent,

RE: **RESEARCH PROJECT**

I am a postgraduate student of University of Nairobi pursuing Masters of Business Administration. As a requirement of my study, I am carrying out a survey on effect of corporate governance on financial performance of Kenya commercial Banks. The success of this study will substantially depend on your willingness and co-operation to provide the information required.

I kindly request you to allow me have a short interview session for data gathering. The attached interview schedule is specifically designed for the purpose of this study only; and all responses will be treated in absolute confidence and anonymity.

Thank you for your cooperation.

Yours Faithfully,

Otieno Miseda Fred

SECTION A: CORPORATE GOVERNANCE PRACTICES (CGPR)

9. Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)

	Questions	1.SA	2.A	3.U	4.D	5.SD
a	BoD has regular meetings					
b	There are many potential conflict of interest between the company and the BoD and BoC					
c	The company has unequivocal list of shares owne by the members of BoD and BoC					
d	The company has an internal written policy regarding BoC membershaving recurrent positions as directors in other companies					
e	The BoD is responsible for vision, mission and Strategic plan					
f	The company provides formal performance appraisal review of the BoD regularly					
g	The company provides formal performance appraisal review of the BoC regularly					
h	The company provides an internal nomination process for the BoC					
i	All candidates are given a written appointment letter as directors.					
j	All candidates are given a written appointment letter as commissioners.					

SECTION B: CORPORATE GOVERNANCE POLICIES (CGPO)

Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

1. Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)

Questions   **1   2   3   4   5**

10. The BOD has regular meetings

11. The following committees are actively functioning in the bank;

      (a) Audit committee

      (b) Compliance committee

      (c) Risk Management committee

      (d) Insurance committee

      (e) Compensation committee

12. Your bank has a written code of corporate governance which covers the specification of;

    (a)The rights of shareholder

    (b) Duties of Directors

    (c) Rules of disclosure

13. To what extend are policies and procedures on corporate governance are used

SECTION C: DISCLOSURE POLICIES AND PRACTICES (DPP)

14. Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)

	Questions	1.SA	2.A	3.U	4.D	5.SD
a	Your bank provides equal access to information for Shareholders and investment analysts					
b	The reports prepared for annual shareholders meeting contain only basic information of sufficient details to enable investment analysts to assess the financial and non-financial performance of the bank					
c	The company publishes and distributes its financial results and management analysis for analysts.					
d	The company posts its financial results and management analysis on the internet.					

e	The company tracks changes in its ownership structure so that any and all voting blocks are known					
f	The annual reports clearly described					

SECTION D: SHAREHOLDER RIGHT AND RESPONSIBILITY (SRR)

Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)

Questions   **1   2   3   4   5**

15. Shareholders are encouraged to attend and vote during the annual

General meetings

16. Rate the way non-financial information (e.g. Information on the Board of Directors):

     (a) High reliable and accurate information

     (b) Speed of transmission

17. There is adequate opportunity for shareholders to receive and review the financial reports in order to ask for questions to be put on the agenda at the annual shareholders' meeting.

18. There is adequate time given during the annual shareholders' meeting for shareholders to ask questions

19. The annual meeting of shareholders decides the following items:

     a. appointment of BoD

     b. compensation of BoD

     c. appointment of external auditors

20. Shareholders are aware of their rights and responsibilities

21. Minorities are well protected

22. Shareholders have equitable treatment

SECTION E: BANK FINANCIAL PERFORMANCE

Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)

	Questions	1.SA	2.A	3.U	4.D	5.SD
a	The bank has had good improvement on return on equity in the last three years					
b	The bank has had good improvement on return on assets in the last three years					
c	The bank has better return on equity than the industry					
d	The bank has better return on assets than industry					

END

APPENDIX C - Data Recording

Data Collection Sheet A – Return on Equity Variables

Variables	2007	2008	2009	2010	2011
Earnings					
Common Equity					
ROE = Earnings/equity					

Data Collection Sheet B - Net Profit Margin Variables

Variables	2007	2008	2009	2010	2011
Net Income					
Operating Income					
NPM = Net Income/Operating Income					

APPENDIX D – List of Commercial Banks in Kenya

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank
6. CFC Stanbic Bank
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Ecobank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. Fina Bank
22. First Community Bank
23. Giro Commercial Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank
27. Habib Bank AG Zurich
28. I&M Bank
29. Imperial Bank Kenya
30. Jamii Bora Bank
31. Kenya Commercial Bank
32. K-Rep Bank
33. Middle East Bank Kenya
34. National Bank of Kenya
35. NIC Bank
36. Oriental Commercial Bank
37. Paramount Universal Bank
38. Prime Bank (Kenya)
39. Standard Chartered Kenya
40. Trans National Bank Kenya
41. United Bank for Africa[2]
42. Victoria Commercial Bank
43. HDFC Bank Limited
44. FirstRand Bank