



SCHOOL OF LAW

A Thesis submitted to the Faculty of Law in partial fulfilment of the requirements for the conferment of Masters in Law, University of Nairobi

STRENGTHENING CORPORATE GOVERNANCE TO CURB CORRUPTION IN BANKS IN KENYA: A CASE STUDY OF DUBAI BANK AND IMPERIAL BANK

By:

KASHINDI EBBY IMBAHALA

REG NO: G62/82367/2015

Prepared & presented under the supervision of:

JOY K. ASIEMA

OCTOBER, 2019.



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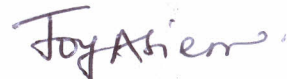


KASHINDI EBBY IMBAHALA

REG NO: G62/82367/2015

This thesis has been submitted for examination with my approval as University Supervisor.

Dated at Nairobi this 1ST day of OCTOBER 2019



JOY K. ASIEMA

**FACULTY OF LAW
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DEDICATION

To Thomas and Leah, my loving parents.

ACKNOWLEDGEMENT

This thesis would not have been possible without the able supervision of Mrs. Joy K. Asiema. Her continuous support and guidance shaped this work and brought it to a successful completion.

I am grateful to my parents and siblings who encouraged me and prayed for me throughout the time of my study.

I am also thankful to my classmates and my colleagues at Ethics and Anti-Corruption Commission for their contribution in one way or another towards this achievement.

Finally, I thank the Almighty God for his grace that kept me going.

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ABSTRACT

The Corruption menace is not only local but also global. It is a major threat to global financial stability and international economic security. Corruption is no respecter of the size or types of business organizations or even their locations. It can crush a firm and create a ripple effect on the firm's stakeholders' livelihoods which are, invariably, pegged on the firm's financial successes and Kenya just like other countries is no exception

Corruption is equally not a respecter of sectors and a sector that has recently felt its terrible hit is the Kenya banking sector. The author examines whether the emergence of corporate governance mechanisms in Kenya has had any tangible results in the eradication of corruption in the banking sector and in doing so, analyses the collapse of Dubai Bank and Imperial Bank and the reasons behind their respective collapse.

The study comprises five chapters. The first introduces the background to the study, the underlying theoretical framework, the hypotheses, and the problem statement among others. The second chapter founds the case study which contains an in-depth analysis of the collapse of Dubai Bank and Imperial Bank as it seeks to establish that weak corporate governance and corruption are the common denominators in their collapse. The third chapter reviews the existing policy, legal and regulatory framework in Kenya on corporate governance and corruption both local and international.

The fourth chapter examines the practice of corporate governance in South Africa and in the United to appreciate best practices. The study wraps up with conclusions from the research findings and proceeds to prescribe recommendations for addressing the challenges facing banks in Kenya.

LIST OF ABBREVIATIONS AND ACRONYMS

ACECA	Anti-Corruption and Economic Crimes Act, 2003
CACG	Commonwealth Association of Corporate Governance
CBK	Central Bank of Kenya
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CMA	Capital Markets Authority
DBKL	Dubai Bank Kenya Limited
DPP	Director of Public Prosecution
EACA	Ethics and Anti-corruption Commission Act
EACC	Ethics and Anti-Corruption Commission
ECT	Electronic Communications and Transactions Act
HCCC	High Court Civil Case
HIV/AIDS	Human Immunodeficiency Virus, Acquired Immunodeficiency Syndrome
IRS	Internal Revenue Service
KDIC	Kenya Deposit Insurance Corporation
KES/ Kshs	Kenya Shillings
MD	Managing Director
NASDAQ	National Association of Securities Dealers Automated Quotations Exchange
NIC	National Industrial Credit Bank
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-operation and Development
PAIA	Promotion of Access to Information Act
PCAOB	Public Company Accounting Oversight Board
SACCOS	Savings and Credit Cooperatives Societies
SEC	Securities & Exchange Commission
SMEs	Small and Medium-Size Enterprises
SOEs	State Owned Enterprises
SOX	Sarbanes-Oxley Act of 2002
U.S./US/USA	United States of America
UK	United Kingdom

UN

United Nations

LIST OF CASES

Imperial Bank Limited (In Receivership) & others v Alnashir Popat & Others, Nairobi HCCC
No. 392 of 2016

Republic v Central Bank of Kenya and KDIC ex parte Alnashir Popat and others, Nairobi
Judicial Review Application No. 43 of 2016

Richardson and David Limited v- Kenya Deposit Insurance Corporation & another [2015] eKLR

Salomon v Salomon and Co Ltd [1897] AC 22

LIST OF STATUTES/CONVENTIONS

Local

Constitution of Kenya, 2010

Anti-Corruption and Economic Crimes Act, No. 3 of 2003

Banking Act, Cap 488 Laws of Kenya

Bribery Act, No. 47 of 2016

Capital Markets Act, Cap 485A Laws of Kenya

Companies Act, Cap 486, Laws of Kenya (Now Repealed)

Companies Act, No. 17 of 2015

Ethics and Anti-corruption Commission Act, No. 22 of 2011

Kenya Deposit Insurance Act, No. 10 of 2012

Penal Code, Cap 63, Laws of Kenya

Public Officer Ethics Act, No 4 of 2003

Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015

Mwongozo- The Code of Governance for State Corporations, 2015

International Instruments/Conventions

African Convention on Preventing and Combating Corruption

Organization for Economic Co-operation and Development (OECD) Protocol to Combat Bribery by Foreign Public Officials in International Business Transactions

United Nations Convention against Corruption

United Nations Declaration against Corruption and Bribery in the International Commercial Transactions

OECD Principles of Corporate Governance, 2015

South Africa

Black Economic Empowerment Act 2003

Companies Act No. 71 of 2008

Electronic Communications and Transactions Act

Employment Equity Act 1998

Labour Relations Act 1995

Promotion of Access to Information Act

King IV Report

South African Code of Corporate Governance

United States

Sarbanes-Oxley Act of 2002

CHAPTER ONE: STRENGTHENING CORPORATE GOVERNANCE TO CURB CORRUPTION IN BANKS IN KENYA: A CASE STUDY OF DUBAI BANK AND IMPERIAL BANK

1.0 INTRODUCTION

1.1 Background to the study.

There exists no standard universal definition of the term corporate governance. Nonetheless, several definitions are presently available which outline the elements or ingredients of corporate governance. Corporate Governance is the manner or mode in which the senior management or board governs an institution's business affairs and entails the processes and structures for setting, and achieving the institution's objectives. Its ultimate objective is the realisation of the shareholders' long-term value while also balancing it with the other stakeholders' interests.¹ For this to be achieved, it concerns itself with the mechanisms of directing and managing the business affairs of a company with the business' prosperity in mind while at the same time maintaining corporate accountability.²

Corporate governance concerns itself with the rules and regulations entailing the processes, procedures, practices and systems governing institutions, the implementation of these rules and regulations and the relationships created thereunder. It seeks to establish an environment that enables transparency, trust and accountability, which are essential for promoting investment that is long-term, enhancing business integrity as well as guaranteeing financial stability.

Being that corporate governance's two main objectives are the realisation of long-term shareholder value and ensuring the business' prosperity, sound corporate governance not only offers accountability in the stewardship of an institution's resources but also encourages their efficient use thus preventing the wasting away or misuse of the resources through vices such as corruption. Sound corporate governance therefore guards against mismanagement, misappropriation and corruption and encourages fundamental values, namely: property rights, accountability, fairness,

¹Peter Rawlings Osebe and Penvilia Chepkemoi, 'Corporate Governance and Banking Sector in Kenya' International Journal of Economics, Commerce and Management Vol. IV, Issue 9 September 2016 pg 493.

²Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015 (the 2015 Code)

transparency, responsibility and rule of law,³ which are fundamental in any market economy. Indeed, corporate governance is illustrated⁴ as an effective tool in reducing corruption incidences, within corporate sectors.

This study appreciates that several scholars and organisations have attempted to define corporate governance and, in the absence of a universal definition, adopts, and hence works with, the aforementioned definitions of corporate governance.

The practice of corporate governance is significant globally and the improvement of its practices is widely recognized as an essential element in reinforcing corporations' long-term financial and economic performance. The late 1990's financial crisis saw corporate governance considered integral to the architecture of global finance. Globalisation of the market place demands frequent review and redefinition of corporate governance's traditional dimensions.⁵ The global recognition and immortalisation of the importance of corporate governance has generated a worldwide discussion on corporate governance and the development of institutional, regional and international standards in response thereof.⁶

The Principles of Corporate Governance, the Commonwealth Association for Corporate Governance (CACG) and the Organization for Economic Co-operation and Development (OECD), are two of the international institutions that acknowledge and recognise the principles of good governance and the Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance (Kenyan Code for Corporate Governance") represent the local sphere.⁷

³Sam Mensah, Kwame Aboagye, Elsie Addo & Seth Buatsi; "Corporate Governance and Corruption in Ghana, Impirical Findings and Policy Implications(Abstract)" Available at <http://unpan1.un.org/intradoc/groups/public/documents/idep/unpan020733.pdf> Accessed 26 August 2018

⁴Sam Mensah n 3

⁵CACG Guidelines – Principles for Corporate Governance in the Commonwealth, at page 1, published in November 1999 by the Commonwealth Association for Corporate Governance and adopted by the Commonwealth Heads of Government

⁶Ron Sockram, "Corporate Governance in the Emerging Economics of the Caribbean: Peculiarities, Challenges and a Future Pathway" The Journal of Values-Based Leadership 9(1) (2016). Available at www.scholar.valpo.edu/cgi/viewcontent.cgi?article=11498context=jvbl Accessed 4 Marcy 2017.

⁷Private Sector Initiative, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance* (Private Sector Corporate Governance Trust, 1999)

The Corporate governance principles gained extra prominence in Kenya in the wake of corporate scandals that saw several banks fold up. The collapse of Dubai Bank Limited and Imperial Bank founds the case study to this study.⁸

The collapse of Dubai Bank in August, 2015, Imperial Bank in October, 2015 and the near collapse of Chase Bank in April, 2016, all happening just within a year's span, with the latter being reopened,⁹ are attributed to corporate corruption among other reasons. While there are several reasons and factors fostering corruption in the banking sector, poor corporate governance structures is the chief. Good corporate governance practices, not only ensure economic growth and an organisation' corporate success but also that the management of the organisation caters for every stakeholder's best interests.

This study seeks to analyse the collapse of the aforementioned banks on the underlying assumption that their collapse was triggered and precipitated by corruption which thrived due to weaknesses in the corporate governance structures within these banks. This study proceeds on the notion that opportunities for corruption and corruption incidences are reduced by putting in place strong corporate governance structures which provide for the necessary checks and balances mechanisms that can be implemented by banks to avoid pitfalls and loopholes for corruption and bribery.

1.2 Statement of the Problem

The emergence of corporate governance structures in Kenya has not necessarily eliminated corruption in the banking sector. The existing policy, legislative and regulatory framework have not incorporated principles of good corporate governance. Corruption has negatively impacted the corporate landscape not only in Kenya but globally as well, where it remains a major threat to global stability and international economic security.¹⁰ Weaknesses in the corporate governance structures in the banking sector have far reaching consequences to the economy of Kenya.

Although the desire for strong corporate governance is on the rise worldwide, with nations including Kenya working towards improving their corporate governance framework, much still

⁸ Ron Sockram (n6) above

⁹ Peter Rawlings (n1) above

¹⁰ Timothy A. Falade Obalade, PhD, "Analysis of Corporate Corruption in the USA: A Descriptive Overview of Recent History" *International Journal of Humanities and Social Science*, 4(5) (2014) 251-259 at p. 251. Available at <http://www.ijhssnet.com/journals/Vol_4_No_5_March_2014/27.pdf> Accessed 30 November 2018.

needs to be done to eliminate the numerous gaps in the existing corporate governance mechanisms and structures. These gaps and loopholes have given room for corporate corruption to flourish at the expense of the economy as witnessed by the unfortunate collapse of the aforementioned two commercial banks.

The role of banks in the financial sector of any growing nation is crucial. Banks provide a channel through which funds are mobilized and directed towards facilitating economic growth and development. A banking sector that is financially healthy will result in economic growth and stability¹¹. There is need therefore for good governance within banks to forestall failures that may destabilize the economy.

At the time of this study Kenya had suffered collapse of several banks in a span of just nine months; Dubai bank, Imperial bank and Chase bank. There were great concerns as the failure had led to huge financial losses to the stakeholders as well as erosion of investor confidence and loss of public trust in the banking sector. Corruption by directors and managers of these banks was said to be one of the reasons for their failure. This study therefore seeks to analyse the corporate governance structures within Dubai bank and Imperial bank and their influence on corruption.

1.3 Research Objectives

1.3.1 General Objective

The study seeks to analyse the corporate governance framework within banks in Kenya and the extent to which weakness therein have contributed to corruption. It thereafter seeks to prescribe solutions to curb the vice.

1.3.2 Specific Objectives

The specific objectives of this study are:

- i. To analyse corporate governance structures in place within Dubai bank and Imperial bank and their influence on the collapse.

¹¹ Robert N. Gathaiya; '*An analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016*' International Journal of Management and Business Studies. Available at <<http://www.ijmbs.com/Vol7/73/1-robert-n-gathaiya.pdf>> Accessed 26 August 2018.

- ii. To establish whether there is a link between weak corporate governance structures and corruption.
- iii. To review the existing policy, legal and regulatory framework for corporate governance and corruption in Kenya and identify any gaps therein.
- iv. To make a comparative analysis of the practice in the United States of America and South Africa to appreciate best practices.
- v. To make recommendations for strengthening the corporate governance structures in order to address corruption in banks in Kenya.

1.4 Research Questions

The study seeks to answer the following questions:

- i. Is there a link between weak corporate governance and corruption in banks?
- ii. Are there gaps in the policy, legal and regulatory framework on corporate governance and corruption in Kenya?
- iii. Are there best practices that Kenya can draw from the United States of America and South Africa to help strengthen corporate governance structures in order to address corruption in banks?
- iv. How can strong corporate governance structures be utilised as a tools for eradicating corruption in banks in Kenya?

1.5 Research Hypothesis

The study seeks to test two hypotheses:

- i. That weak corporate governance structures within banks creates room for rampant corruption leading to their collapse.
- ii. That corruption in banks can be reduced by use of strong corporate governance structures.

1.6 Literature Review

Several publications and articles previously published by authors who have reviewed the topics of corporate governance and corruption enriched this study. These articles and publications not only provided the base on which this study is premised but also give the author the opportunity to identify gaps in those existing literatures.

Wu, X., in his article titled, '*Corporate Governance and Corruption: A Cross-Country Analysis of Governance*¹² concludes that reduction of corruption in corporations is one consequence of good corporate governance. He argues that levels of corruption in an organisation may be determined by the application of corporate governance.

At this juncture, it is critical to acknowledge that this study is also founded on agency theory; which will be examined in detail on the discussion on theoretical framework. Nevertheless, it proceeds on the assumption that agency relationships are common in financial management due to the nature of the business. By this theory, it is exemplified that when one person manages the finances on behalf of the other, an agency relationship arises by default. The managers and directors are the agents as they influence and make decisions on behalf of other key stakeholders including the shareholders.

Wu empirically tests two hypotheses exploring the explicit link between several corporate governance measures and corruption levels in organisations relying on datasets from several countries.¹³ His findings indicate that corporate governance standards greatly impact the effectiveness of fighting corruption. It is Wu's belief that principles of good corporate governance impose constraints on the corrupt officials resulting in firms' improved operating performances and reduced levels of corruption.

In the first hypothesis, Wu posits that countries where the corporate boards' accountability to shareholders is greater will experience lower corruption levels. He argues that accountable, strong, competent and independent corporate boards which are truly committed to the shareholders' interests, provide the necessary credibility to managers to be bound by a "no bribe" policy, which deters corrupt officials from making extortion demands and enhances the managers' bargaining power in dealing with corrupt officials who may make such demands thus leading to an overall reduced bribery incidences in such firms.

Wu's second hypothesis is that countries with higher accounting information reporting standards experience lower corruption levels. He argues that enhanced regulations and rules on accounting information reporting and the transparency in their disclosure is a great bulwark to the firms'

¹²Wu, X., '*Corporate Governance and Corruption: A Cross-Country Analysis. Governance*' (2005), *An International Journal of Policy, Administration and Institutions*, 18 (2), 151-170.

¹³ Ibid

internal monitoring and control system. It results in reduced information asymmetry which enables the principals to effectively monitor the agents' behaviours thus increasing the probability of bribery detection and effectively deterring the demand for corrupt practices as managers engaged in corruption find it difficult to hide or account for the bribe payments.

Unlike Wu's study which focuses narrowly on accounting information transparency this study takes a wider approach on the concept of transparency. It seeks to highlight transparency as one of the National Values and Principles provided under Article 10 of the Kenyan Constitution of 2010 and to emphasize that non-disclosure and transparency is one key principle and basis upon which all actions, decisions are undertaken by the board being the decision making arm of corporate organizations. This study focuses on Principle 1 of the CBK's Prudential Guidelines¹⁴ on Leadership and Integrity requiring boards to base their leadership on ethical foundations effective results. Good governance – responsible and effective leadership, defined by the ethical values of transparency, fairness and responsibility, forms the basis of this study.

Dr.Musili Wambua, in his article, '*Corporate Governance and Corruption in Kenya*',¹⁵ focusing majorly on Kenyan public corporations examines their collapses and causes of poor corporate governance. He concludes that lack of accountability and transparency, corruption and political patronage are the main reasons for poor corporate governance and that severing political control from the governance of state entities and insulating the operations of corporations from political patronage enhances good corporate governance within the public sector.

This study, however, focuses mainly on banking institutions whose governing body is a board of directors granted the obligation to run the institutions on behalf of other key stakeholders and seeks to establish that corruption within the Kenya banking sector is an outcome of poor corporate governance and is premised on the fact that if we strengthened our corporate governance structures then corruption will be curbed completely.

¹⁴ CBK Prudential Guideline for Institutions Licensed under the Banking Act; Guidelines on Corporate Governance CBK Prudential Guidelines 2013

¹⁵ Paul Musili Wambua, *Corporate Governance and Corruption in Kenya* (Claripress Nairobi 2008)

Ann Murugu Maina¹⁶ seeks, in her study, to establish the influence, if any, of corporate governance on management of finances in tertiary institutions within Nakuru County, Kenya. Her aim is specifically on how corporate culture, leadership, legal responsibilities and transparency on management of finances by these institutions is influenced. She adopted a cross-sectional research design and her study reveals that corporate culture, corporate leadership, legal responsibilities and transparency had significant influence on management of finances on these institutions. Her study concludes that the said institutions practiced various forms of leadership and that corporate leadership led to substantive improvement of financial management.

Her study further concludes that greater adherence to legal responsibilities was likely to result in moderate enhancement in financial management in tertiary institutions and infers that transparent governance, transparent faculties, and transparent remuneration system were important components of transparency in that they influenced management of finances in these institutions. The corporate culture in tertiary institutions should be such that it facilitates more effective management of resources, particularly funds. The study further recommended inculcation of facets of corporate leadership that are likely to guarantee improved financial management in tertiary institutions. The study recommended that there is no legal stipulation that should be violated for whatever reasons by the tertiary institutions. In addition, it was recommended that there ought to be regular financial reporting by the department concerned as opposed to relying only on annual financial reports. This study however looks at a wider spectrum since it focuses on financial institutions in the whole country and not limited to tertiary institutions within a single county.

Kinyua Mercy Gathoni,¹⁷ in her paper, posits that weak corporate governance regulatory framework and legal enforcement mechanism result from the failure to prescribe the precise duties of directors, to whom the duties are owed and the consequences for breach of those duties. Thus,

¹⁶ Ann Murugu Maina, '*Influence of Corporate Governance on financial management in tertiary institutions in Nakuru County, Kenya.*' A Research Project Submitted to the School of Human Resource Development in Partial Fulfilment of Award of Master of Business Administration (Finance Option) in The Jomo Kenyatta University Of Agriculture And Technology

¹⁷ Kinyua Mercy Gathoni, 'A Case For Statutory Codification Of Directors' Duties In Enhancing Good Corporate Governance In Kenya: A Case Study Of National Bank Of Kenya.' Available at http://erepository.uonbi.ac.ke/bitstream/handle/11295/76674/Kinyua_A%20Case%20for%20Statutory%20Codification%20of%20Directors%E2%80%99%20Duties%20in%20Enhancing%20Good%20Corporate%20Governance%20in%20Kenya-a%20Case%20Study%20of%20National%20Bank%20of%20Kenya.pdf?sequence=3&isAllowed=y Accessed 27 July 2018

in her opinion, companies in Kenya are unlikely to see the light of day in good governance unless the current laws are reviewed to reflect changing economic trends and to take into account the evolving duties of directors to company stakeholders.

Her study seeks to assess the how much the Companies Act, Cap 486, Laws of Kenya (Now Repealed) impedes good corporate governance practices in Kenya specifically illustrating that performance of company directors in Kenya is undermined by a regulatory framework that fails to define directors' duties with specificity and clarity leading to corporate collapses and failures. She argues for reform of the corporate governance regulatory framework calling for codification of directors' duties in statute for purposes of enhancing good corporate governance. She also argues that corporate failures are far from over and that the board of directors has largely been blamed for these failures despite reforms.

Simeon Wanyama, Bruce Burton and Christine Helliar,¹⁸ probe perceptions on corporate governance practices in Uganda. Their findings suggested that attempts to improve practice are hindered by the weaknesses that abound the underlying frameworks and pervasive corruption. Their findings also indicated that mere rise of robust governance regulations and codes does not guarantee improved corporate governance practices.

1.7 Theoretical Framework

This section reviews theories related to and associated with corporate governance and corporate corruption. The theories discussed herein include the Agency Theory, Efficient Grease Theory and a reference to Stakeholder Theory. They are relevant to, and underpin, this study.

This study analyses the efficient grease theory to elucidate the perception by some who view corruption within the banking sector as a means to facilitate business rather than a vice. It also relies on the agency theory in linking corruption in the banks to the selfish intentions of these institutions' managers

¹⁸ Simeon Wanyama, Bruce Burton and Christine Helliar, "Frameworks Underpinning Corporate Governance: Evidence on Ugandan Perceptions" *Corporate Governance: An International Review*, 2009, 17(2): 159–175 available at https://www.researchgate.net/publication/228121502_Frameworks_Underpinning_Corporate_Governance_Evidence_on_Ugandan_Perceptions Accessed 22 June 2017.

1.7.1 Agency Theory

The agency theory is prominent in matters of corporate governance and takes a two-pronged approach; it categorises the corporation into two participants: managers and shareholders; and propounds that generally human beings are self-interested.¹⁹

While managers possess the discretion to bind the corporation to any transactions and contracts they deem appropriate, the discretion should be exercised responsibly and in the shareholders best. It is argued that agency theory, which suggests that the management of an organisation is to be undertaken on behalf of the owners of the organisation, provides a platform for ensuring responsible exercise of discretion by managers and to the benefit of the firms' shareholders.²⁰

It is argued, by Rappaport and Stewart, among others, that, by implication, responsible management of the organisations' value creates benefit not only to the firms' shareholders but also to the society at large and the organization's all other stakeholders and that the main focus is on how performance is managed on behalf of the firm's shareholders and how it is reported to them.²¹

Agency Theory describes the problem that results from separation of ownership (shareholders) and control (managers) thus giving rise to an agency relationship with the shareholders as the principal and the managers as the agent who acting on behalf of the principal, do so on account of the delegated decision-making authority.²²

Agency Theory argues, thus, that managers, as mere custodians, are tasked with managing the organisation and its operational activities in the owners' best interest. Accordingly, all other stakeholders have little, if any, relevance to the running of the business and, any benefit that they may get therefrom, is purely coincidental.

¹⁹Uwuigb eOlubukunda Ranti, 'Corporate Governance and Financial Performance of Banks: A Study of Listed Banks in Nigeria' A Thesis in the Department of Accounting submitted to the School of Postgraduate Studies, Covenant University, Ota, Ogun State in partial fulfilment of the requirements for the award of the Degree of Doctor of Philosophy (Ph.D) in Accounting (2011) at p.40

²⁰ David Crowther and Renu Jatana "Agency Theory: A cause of failure on Corporate Governance" Available at <<https://pdfs.semanticscholar.org/9998/2e30599c4ec2f268fda15b35bfeedb85dad2.pdf>> Accessed 27 July 2018

²¹ Ibid

²² Jensen and Meckling, *Theory of the Firm: Managerial, Agency Costs and Ownership Structure* (1976).

Criticism against agency theory's singular focus on shareholders as being the only intended beneficiaries abound arguing that the intended beneficiaries of an organisation should extend to the society at large.

The Stakeholder Theory views an organisation as having several categories of stakeholders each of whom should benefit for their involvement with and in the business and that such proportional or equitable distribution results in maximisation of the business' benefits.

Nevertheless, the agency theory and the stakeholder theory have a point of congruence – responsible management of the organisation results in maximisation of returns. While the latter focuses on all stakeholders, the former notes that the returns are for the benefit of the shareholders and that this maximization is realised over a long period of time when the management focus on optimising the business' performance thus resulting in maximal returns to all stakeholders.²³

The agent is expected to execute their role in the best interest of the principal. However, agency theory argues that it is not a given since the agent may put his interest before that of his principal thus creating an agency problem – the clash of the conflicting interests; with the principal desiring to maximize his wealth while the self-interested agent intent on misappropriating the funds. To protect his interests, the principal will need to monitor the agent's activities thus incurring some additional costs.

The agency problem, in the case of banks, is complicated than in other firms given the dynamics involved. For banks, there are two tiers of shareholders: the owners (initial founders of the bank) who staked their funds and there depositors who are considered shareholders by virtue of their deposits which the bank may utilize in its investment. Directors and senior management as agents are therefore conflicted on which interests they should meet. It is thus easy for the agents to choose their interests over the shareholders' interests. In their selfish endeavours, they are highly likely to engage in corrupt practices.

²³ Crowther and Jatana (n19) above

1.7.2 A critic of the Agency Theory

Stewardship theory, developed by Donaldson and Davis (1991& 1993),²⁴ viewed as the opposite of the agency theory, since its focus is on empowering and facilitating managers rather than monitoring and controlling them, is offered as an alternative to Agency Theory.

Stewardship Theory view managers as stewards working in the shareholders' best interests and are committed to the organization's objectives and in the prosperity of the business working collectively to ensure that the business prospers. In so doing, they maximize the shareholders' wealth while promoting their own interest granting them satisfaction when the business prospers.

This theory however proves problematic in the corporate world given its dependence on parties' relationship and a mutual appreciation of the context where agreements are made. It is arguable that where there is a single principal and a single agent, it is less problematic since the parties presumably know each other.²⁵ The complexity within the corporate world is that the shareholders are equated to principals and in the case of large corporations, the number of the shareholders is a sheer mammoth, fluid in nature and unknown to the managers. In such a setting, it is difficult to have a proper agency since the principals invest not in future of the company but rather to grow capital or to draw dividends and thus hold onto the shares as property over a particular period of time.

This problem worsens especially where manager of financial institutions are appointed by the shareholders as fund managers to buy and sell the shares on their behalf with the fund managers making their cut in proportion to the fund's value growth. In such a transactional state, the shares are not regarded as part stake in the business but rather as commodities thus further defeating the creation of an agency.

Nevertheless, Agency Theory remains the most applicable theory for this study with the assumption that since human beings are egoistical self-interests take precedence. Also, the collectiveness nature of the stewardship theory makes it difficult to hold anyone accountable since several people are simultaneously responsible.

²⁴David, P. & Miguel, A. A. "When Agents Become Stewards: Introducing Learning in the Stewardship Theory" at pg.1, available at <http://www.iese.edu/en/files/6_40618.pdf> Accessed 22 June 2017.

²⁵ Crowther (n19) above

1.7.3 Efficient Grease Theory

The Efficient Grease Theory, propounded by Kaufmann and Jin Wei, argues that corruption is sometimes beneficial in alleviating delays and inconveniences resulting from ill functioning institutions which abound with red-tape bureaucracies assuring nothing but inefficiencies and thus greatly impeding on economic activity thus calling for some “speed” or “grease” or money to aid circumventing the inefficiency.²⁶

The ‘moralistic view’ of corruption²⁷ offers the best shot at getting to the root of the efficient grease theory. This moralistic view examines how corruption can help foster development arguing thus, that moral grounds should not be the sole yard stick for judging corruption. This theory revolves around bureaucratic inefficiencies, which include, among others, sluggishness which is argued can be cured by corruption since bribes incentivise bureaucrats to speed up processes where sluggishness is the norm.²⁸

This theory, however, does not enjoy the support of many scholars as it seeks to recommend the application of the vice that many are trying to eradicate. This study discourages corruption in corporate sectors and recommends emulating the principles of corporate governance in bid to eradicate graft.

1.8 Justification of the Study

The study implies that corruption is a menace which must be eliminated and holds the view that all sectors should cooperate in eliminating corruption. Specifically, the study recommends the application of good corporate governance principles in the banks in Kenya because of their key role in the economy and that bank failures can stifle economic growth noting that numerous industries rely on the financial institutions for their day to day operations.

Poor governance of financial institutions erode public confidence in them as will be demonstrated by the analysis of the collapse of Dubai Bank Limited and Imperial Bank Limited, which are the case studies for this study.

²⁶ Huntington S. P, *Political Order in Changing Societies* (New Haven, Yale University Press, 1968) Available at <www.ifs.u-strashg.fr/large/publications/2008/2008-06.pdf> Accessed on 10 October 2016

²⁷ Pierre-Guillaume Meon and Laurent Weil, “Is Corruption an Efficient Grease?”, Université Louis Pasteur Strasbourg. Available at <www.ifs.u-strashg.fr/large/publications/2008/2008-06.pdf> Accessed 10 October 2016

²⁸ Ibid.

This study argues that banks can deal with corruption by strengthening their corporate governance mechanisms and structures. It is notable that both the private and public sector across the globe have utilized corporate governance practices to address governance challenges. These practices include the application of principles such as transparency, accountability, efficiency and effectiveness. The ambit of corporate governance can further be broadened to include principles that expressly deal with corruption.

This study will help policy and law makers realize that corporate governance if properly adhered to can be an effective tool in addressing corruption in banks in Kenya. Policymakers should, therefore, incorporate corporate governance into the various laws regulating the banking sector. Banks will also benefit from this study as it will provide guidelines for internal mechanisms and controls for dealing with corruption. Researchers intending to carry out studies in this area will also find this study to be informative to the extent of their research.

1.9 Scope of the Study

This is a desktop research conducted on the collapse of Dubai Bank and Imperial Bank within the Republic of Kenya. The study focused on these two bank because they had just collapsed and it was important to establish what had led to their collapse. The area of focus is corporate governance structures within these bank with specific interest on utilization of strong corporate governance structures to curb corruption in the banks in Kenya.

Although corporate governance concerns in the banking sector is a global issue, the research is mainly concerned with Kenya as the country of focus. It looks into how Kenya can regulate its banks by enhancing a framework for strong corporate governance to boost its economy and financial stability. Other jurisdictions and their laws will only be referred to.

1.10 Research Methodology

This is primarily a desk-based study and it largely entails the utilisation of secondary data. It scrutinizes and examines the relevant existing data to answer the research questions. The preference for secondary data over primary data is the belief that if primary data is collected, it may end up replicating previously collected data and that may not necessarily add value to this study. Further, primary data may end up being quantitative as opposed to qualitative which is more useful to this study.

Sources of the secondary data includes among others; the Kenya Constitution, 2010, international instruments, statutes on corruption and corporate governance, judicial precedents (both local and international), journals, scholarly articles, reported studies, reports, dissertations, newspaper articles, working papers and internet sources. This study makes a qualitative analysis of these data.

Finally, the comparative method²⁹ of research will be employed. This study examines and compares how different jurisdictions have dealt with corruption in the banking sector and how corporate governance has been utilized to effectively curb this vice. The aim will be to establish whether Kenya is on the right track and to appreciate best practices.

1.11 Limitations of the Study

The study seeks to analyse sources of secondary data. No primary data will be collected or obtained as there currently exists a lot of primary data on corporate governance and corruption. It is the author's view that collection of primary data will lead to replication of already existing data. This will be of no much value to the research.

To the extent above, this study may hence be disadvantaged as the author will not have the opportunity to collect data directly from the source. Exclusive reliance on secondary data will therefore be a limitation to this study.

The study will also focus on the banking industry with emphasis on Dubai Bank Limited and Imperial Bank Limited, both of which have collapsed in the recent years. While there are many banks that have collapsed over the years with corruption being the major contributor to their downfall, this study only focuses on these two.

1.12 Chapters Breakdown

1.12.1 Chapter One

The chapter is on the research proposal of the study. It is the study's introduction chapter to the study and lays down its background, the problem statement, the study's objectives, hypotheses,

²⁹ The comparative method is the system of comparing different societies or groups within the same society to show whether and why they are similar or different in certain aspects.

See Comparative Method in Sociological Research. Available at <<http://www.oppapers.com/essays/comparative-method-Sociological-Research/18843>> Accessed 24 September 2016

research questions, literature review, theoretical framework, research methodology, limitation of the study and chapter breakdown.

1.12.2 Chapter Two

This chapter interrogates the link between corruption and corporate governance in banks. It carries an in-depth analysis and case study of Dubai Bank and Imperial Bank to prove that corruption was a major contributor to the failure of these banks. It also seeks to establish whether weaknesses in the corporate governance measures within these banks led to the said corruption.

1.12.3 Chapter Three

This chapter explores the existing policy, legal and regulatory framework in Kenya on corporate governance and corruption. It examines the national policies and laws on corporate governance, alongside the policy, legal and regulatory framework on corruption. It additionally looks at international laws, instruments or treaties that Kenya has ratified. It will also look at case laws relevant to this study. The chapter will then focus on the inefficiency of these laws by analysing views from various stakeholders affected by the laws. It will further examine how corruption can be reduced in banks by use of strong corporate governance structures.

1.12.4 Chapter Four

This chapter entails a comparative analysis of how other jurisdictions (United States of America and South Africa) have utilized corporate governance to address corruption within their banking industry. It compares best practices from these jurisdictions with those of Kenya and aims at identifying gaps within the corporate governance practices in the Kenyan banking sector and lessons that can be borrowed from these jurisdictions.

1.12.5 Chapter Five

This study's final chapter comprises the conclusion and recommendations. Conclusions are informed by the research findings and recommendations are made to provide solutions to the research problem.

2.0 INTRODUCTION

This chapter entails the case study and proceeds with an in-depth analysis of the collapse of Dubai Bank and Imperial Bank as it seeks to establish the link between weak corporate governance and corruption in banking institutions. It aims to demonstrate that corruption was a major contributor to the failure of these two banks and that corruption occurred as result of weak corporate governance measures within the said banks.

2.1 Dubai Bank

2.1.1 Receivership by the CBK

The Central Bank of Kenya (CBK) placed Dubai Bank Kenya Limited (“DBKL”, “Dubai Bank”) under statutory management on the 14 August 2015 and Kenya Deposit Insurance Corporation (KDIC) was appointed as the receiver manager pursuant to the provisions of the Deposit Insurance Act, 2012.³⁰ Section 54 (1) (a) of the Deposit Insurance Act empowers the CBK to appoint a Corporation as the liquidator of an institution where, *inter alia*: the institution is found incapable of paying its debts; a winding-up order is made or a resolution for voluntary winding-up is passed against the institution; the institution is unable to pay sums due and payable to its depositors or creditors; and or the CBK finds that an institution’s liabilities exceeds the value of its assets. The CBK decision took into consideration the need to safeguard the interests of the bank depositors, members of the public and creditors as provided for under Sections 43 (1), (2) and 53 (1) of the Kenya Deposit Insurance Act, 2012.

On 24 August 2015 KDIC submitted a report to the CBK on Dubai Bank’s financial health indicating that it was beyond salvageable recommending that liquidating the bank was the only feasible option given its financial woes.³¹

³⁰ Section 54

³¹ Robert N. Gathaiya; ‘An analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016’ International Journal of Management and Business Studies. Available at <<http://www.ijmbs.com/Vol7/73/1-robert-n-gathaiya.pdf>> Accessed 26 August 2018

2.1.2 Background to the Collapse

Numerous concerns had been raised on the operations of the bank. Key amongst the concerns were made by one of its customers, the late Jacob Juma. Through a letter dated 17 March 2015, and addressed to the CBK, Jacob Juma levelled several accusations of malpractice against Dubai Bank and questioned whether the lender was licenced to carry out banking services.³² Even though the Bank did allay most of the fears raised by its customer, it failed to convince the CBK not to place it under statutory management. Around March, 2015, Jacob Juma, after noting that the bank was facing liquidation, warned members of the public against transacting with the bank.

The collapse of Dubai Bank was, however, progressive. Its collapse was as a result of blatant breaches of the banking laws. The main culprits were the directors who conducted their activities negligently. They breached the trust placed upon them by shareholders and stakeholders of the bank.

It was established that the bank was in breach of its daily cash reserve ratio as it was suffering from liquidity and capital deficiencies. Its fate stood sealed on the revelation that it was in breach of its cash ratio requirement and failed to meet its immediate obligations, to the Bank of Africa Kenya, of Kshs. 48 million. The bank's daily cash reserve ratio was being closely monitored by CBK since 14 July 2015. It had contacted the bank in an attempt to remedy the situation but the bank failed to comply with CBK's directions and orders on several occasions.³³ Eventually, the bank was unable to fulfil its financial obligation as required by the Banking Act³⁴ forcing the CBK to consequently close it down for several reasons including among others, failing to honour financial obligations, failing to maintain adequate provisions for non-performing loans as well as weak corporate governance.³⁵

After Dubai Bank was placed in receivership, Richardson and David Limited, one of its largest depositor initiated a suit seeking to block the bank's liquidation arguing that KDIC's decision to advertise the bank's assets would, in the long run, be detrimental to creditors and depositors since the bank will be stripped off of all its assets. Hassan Zubedi, the bank's Chairman and Founder

³² Victor Juma, 'How CBK ignored whistle-blower red flag on Dubai Bank' *Business Daily Africa* (24 August 2015)

³³ Khalfan Abdallah, CIFE, Manager(Head) PDSC at Gulf African Bank Ltd

³⁴ BD Africa.com Reporter, 'Dubai Bank Kenya placed in Receivership for a Year' *Business Daily Africa* (24 August 2015)

³⁵ Khalfan Abdallah (n88) above

also objected to the liquidation arguing that the allegations levelled against him were malicious and false. Consequently the High Court halted the bank's dissolution holding that CBK's move to wind up the bank was premature. While holding that CBK had abused its supervisory powers, the Court Judge stated as follows:

"... Dubai Bank's problems are not recent. The CBK is trying to shield its lack of inspection and is attempting to escape scrutiny."³⁶ "The liquidation of Dubai Bank is suspended by order for 60 days. The CBK is to consider the proposal by Dubai Bank..."

Some of the reasons for Dubai Bank's collapse and which were highlighted in the case of *Richardson and David Limited -vs- Kenya Deposit Insurance Corporation & another*³⁷ include the following:

- a) *DBKL was insolvent to the tune of Kshs. 1,307,000,000.00.*
- b) *DBKL's liquidity ratio was 0.5% far below the statutory minimum of 20%.*
- c) *DBKL's capital was way below the statutory minimum of Kshs. 1,000,000,000.00.*
- d) *The Board of the DBK comprised of three (3) Directors less than the minimum 5 board members as required by the Banking Act.*
- e) *Cash balances were grossly overstated.*
- f) *Non-disclosure in its books of accounts of contingent liabilities comprising guarantees and letters of credit (LC) totalling to over 3 billion shillings.*
- g) *The DBKL held a non-performing loan portfolio of Kshs. 4,163,000,000.00.*
- h) *Incidents of parallel, unofficial and undeclared banking transactions.*
- i) *Several unapproved and unsecured loans and other transactions entailing guarantees and overdrafts advanced to the defendants or to companies linked to the banks Chairperson, Mr. Zubedi.*
- j) *DBKL's failure to honour customer instructions to remit monies deposited by such customers, to third parties involving a sum in excess of Kshs. 41,000,000.00.*
- k) *DBKL had failed to pay a sum of Kshs. 48,000,000.00 due to Bank of Africa Limited, following a forex transaction.*

³⁶ Khalfan Abdallah (n88) above

³⁷ [2015] eKLR

- l) *There were 7,743 deposit accounts with outstanding balances in excess of Kshs. 1,355,000,000.00.*
- m) *The DBKL was facing litigation at the High Court of Kenya at Milimani, over a claim of SAR 42,000,000.00 allegedly due to M/s Universal Metal Coating Company Limited, following alleged dishonoured Letter of Credit issued by the DBKL; **High Court Civil Case No. 278 of 2014***
- n) *Investigations also established that the bank's Chairman, Mr. Zubedi, contravened the provisions of the Banking Act Cap 488, by being both an Executive and a non-Executive director of the board and had absolute control over the bank's operations and affairs.*
- o) *Suleiman Enterprises Company, M/s Africa Energy Limited, Kemu Salt Parkers Production Company, Kamp General Engineering Company and Maestro Properties Company, all associated with Mr. Zubedi, were beneficiaries of large questionable loans and other forms of credit.*
- p) *Mr. Hassan Ahmed Abdul Hafedi Zubedi (Mr. Zubedi) who was at all material times the Chairman of Board of the Bank, held over 344 title deeds in his safe within the Bank premises for various properties across the Republic of Kenya some of which belonged to the Mr. Zubedi and/or his related companies."*

From the foregoing, it is noteworthy that the collapse of Dubai Bank can primarily be attributed to the failure by the bank's management to adhere to principles of corporate governance. The Management of the said Bank's flouted the law governing bank operations and principles of corporate governance. The principles flouted include shareholders' role in corporate governance, transparency and disclosure and the rights of the shareholders and key ownership functions. The disclosure and transparency principle provides for a corporate governance framework that ensures disclosure that is timely and accurate regarding the corporation' material matters, including its governance, performance, financial situation and ownership.

It was stated that before the collapse of Dubai Bank, several firms associated to the owner, received loans of approximately Kshs 1.3 billion authorised by the bank's management. The Crowe Horwath East Africa, Audit Report placed the banks sour loans ratio, as at December 2015 at 62.5 per cent. The auditors informed the National Assembly that three-quarters of Dubai Bank's unsecured loans and overdrafts was distributed among few well-connected pseudo-businessmen

including, among others, Mr. Cyrus Jirongo who through his Sololo outlets owed the bank Kshs.103.2 million, Geoffrey Asanyo, former Kanu Chairman, Nakuru Branch, owed the bank Kshs 412.6 million and Savannah Cement Chairman Benson Ndeta owed the bank Kshs 62 million respectively.

Shockingly, even the bank's Managing Director Mr. Binay Dutta and its Chairman Mr. Hassan Zubeidi were involved in dubious activities before the collapse of the Bank. Mr Dutta, for instance, issued a share sale involving Turkish firm, TunascoInsaat, whose co-owner wanted the winding up of the bank for failing to pay him \$544,900 (Kshs 2.8 million) after Dubai Bank held its ground that the guarantee documents issued to Mr. Sharrif were inauthentic as they bore neither its company seal nor its chairman's signature and as such raised suspicion of a scheme to defraud the bank being perpetrated by Mr. Dutta, Mr. Shariff and Mr. Tunc.

Dubai Bank sued Mr. Dutta a day after the expiry of the ultimatum for settlement of Mr Tunc's debt expired³⁸ where CBK was successfully enjoined as an interested party seeking the protection of the depositors' funds from the attendant risk. The court agreed and consequently restraining the commencement of proceedings to wind up Dubai Bank by Mr. Tunc before final determination of the suit.

However, just days before the substantive hearing of the matter, Mr. Dutta left the country in an attempt to delay its hearing. The bank claimed that Mr. Dutta had had backside dealings and meetings with Mr. Tunc's lawyers where he had offered to personally pay Mr. Tunc the Kshs 52.8 million in monthly instalments of Kshs 400,000 which deal he did not fulfil as evidenced vide the demand letter dated 18 December 2014 from Mr. Tunc's lawyers granting Mr. Dutta thirty days to settle the debt

The brief exposition of the events preceding the collapse of Dubai Bank, indicate failure to comply with the OECD Principles of Corporate Governance played a major role. The collapse was occasioned by the conduct of top officials who engaged in in corrupt deals and the blatant disregard of the provisions of the law. Ideally, the shareholders ought to have been promptly notified by the bank's Board as soon as it realized that some members of its management were colluding with

³⁸ Brian Wasuna, 'Dubai Bank boss flees as CBK moves to probe lending deal' *Business Daily Africa* (29 May 2015)

top-tier businessmen to defraud the bank.³⁹ Moreover, the Bank's management's effrontery to cook its books of account and submit them to the CBK demonstrates collusion between Dubai Bank's Board members and some CBK Board members.⁴⁰

2.2 Imperial Bank

2.2.1 Receivership

On 13 October 2015, barely a few months after placing Dubai Bank under receivership, CBK placed Imperial Bank under statutory management vide Gazette Notice Number 7715 in the Kenya Gazette Special Issue Volume CXVII – No 111 effectively suspending the bank's banking services thus prohibiting the bank from taking any deposits or honouring any demands, from customers, for withdrawals or access to the deposited funds.

CBK took this drastic move to safeguard depositors' and creditors' after discovering inappropriate banking practices, which it termed, "unsafe and unsound conditions for transacting business," taking place within the bank and accordingly placing it under the statutory manager, Kenya Deposit Insurance Corporation (KDIC)⁴¹ for twelve months.

Imperial Bank had about 53,000 customers and an estimated deposit of KES 58 billion when it was placed under management. On 21 June 2016, the CBK appointed National Industrial Credit Bank (NIC) as an Asset and Liabilities Consultant for Imperial Bank (In Receivership). When the KDIC initiated the liquidation of Imperial Bank, NIC, which was charged with returning deposits to the bank's customers was allowed to acquire some of the bank's deposits, assets and liabilities.⁴²

From the date of the special declaration of the bank's receivership, and during the period the bank was under statutory management, the bank's front office operations were grounded save for the collection of loan re-payments as KDIC kept the bank's branches open so as to allow debtors to service their obligations.

³⁹ Jacob Owuor Ogola et al, 'The Effect of Corporate Governance on Occurrence of Fraud in Commercial Banks in Kenya' *The International Journal of Business & Management* (2016)

⁴⁰ Victor Juma, '7,000 Dubai Bank customers face uncertain wait for deposits' *Business Daily Africa* (17 August 2015)

⁴¹ Khalfan Abdalla (n88) above

⁴² Robert Gathaiya (n 86) above

The commencement of the receivership brought with it numerous litigation in court with nearly all the parties involved seeking to protect their interests. Among them were the following matters; *Nairobi Judicial Review Application No. 43 of 2016 (Republic –versus- Central Bank of Kenya and KDIC ex parte Alnashir Papat and Other)* and *Nairobi HCCC No. 392 of 2016 (Imperial Bank Limited (In Receivership) & Others -versus- Alnashir Papat & Others)*, by which well-founded claims for regulatory negligence were levelled as against the Central Bank of Kenya. Additionally, there have been claims that the directors of the bank were colluding with the CBK officials. It is alleged that in the imperial bank’s case, the regulator displayed some sense of bias in favour of the bank’s officials.⁴³

2.2.2 Discovery of the Fraud and Dubious transactions

The death of Janmohamed, then Imperial Group’s Managing Director (MD) on 15 September 2015 seemed to have granted the bank a new lease of life. New appointments were made and the bank took that opportunity to assure depositors that it was committed to ensuring a strong experienced leadership to further its strategies, record of service to customers and the society in general and growth trajectory. The then Head of Credit, Naeem Shah was promoted to Acting Manager Director while the then Chief Finance Officer (CFO), James Kaburu was promoted to Deputy Managing Director.

On 21 September 2018, Shah and Kaburu made revelations to the bank’s Board implicating the late Janmohamed of fraudulently disbursing loans running into billions of shillings to close business associates and friends while flouting the banks internal lending procedures and prudential guidelines and systematically hiding the transactions in the books of accounts by unilaterally forcing, intimidating and threatening the CFO to find creative accounting methods to dodge the scrutiny of the board of directors.⁴⁴

On 25 September 2015, Alnashir Papat, Imperial Bank Chairman, convened an emergency board meeting in response to the Shah and Kaburu’ revelations. The bank’s board charged Omurembe Iyadi, its Audit Committee Chairman with leading an investigation into the allegations of fraud following which the directors would seek a meeting with the CBK Governor to apprise him on the discovery. However, this was subject to the finalization of the investigations. The audit team was

⁴³ Section 4

⁴⁴ Dominic Wabala, “How Imperial Bank fraud was discovered” The Star(15 February 2016)

also tasked with the obligation of contacting clients who had been mentioned to verify the allegations. The board also procured the services of an independent external forensic advisor on 2 October 2015 after internal investigations proved to be very slow and with preliminary findings implicating senior officers of the bank. Therefore, it was only prudent that an external investigator be appointed.⁴⁵

The London based forensic auditors, FTI Consulting, were called on 5 October 2015 and arrived in the country the following day. An emergency board meeting was called on 7 October 2015 during which the board resolved to take all necessary measures to protect the financial position and records of the bank and accordingly passed the resolution for the appointment of FTI Consulting to conduct a forensic audit to determine the accurate financial position of the bank. The team began its preliminary investigations and secured the bank's transaction database. They also analysed customers' accounts and ledgers. They also reviewed instructions relating to suspect customer accounts.⁴⁶

2.2.3 Findings from the Investigations

The FTI Consulting audit established discrepancies between the actual figures of overdrafts, unsecured loans, deposits and investments and those previously reported to the bank's Board and that the former group managing director and accomplices within and without the bank, including some personnel at CBK, had been operating a scheme of illegal and fraudulent disbursements that was operational for several years and costing the bank approximately 380 million dollars in customer deposits and bad loans for which the shareholders blame the CBK officials for their role in the collusion.⁴⁷

The upshot of the collusion, which ran for a period of 13 years, was the altering of the bank's list of top borrowers and the doctoring of financial reports which were nonetheless approved by a CBK.⁴⁸ The colluding Imperial Bank Managers, in return, gifted their counterparts at CBK with loans that remained unrepaid in most cases⁴⁹ and with employment opportunities for relatives or

⁴⁵ Ibid

⁴⁶ Ibid

⁴⁷ Ibid

⁴⁸ Owaahh, 'The Sack of Imperial Bank: Epilogue' (1 October 2016) available at <<http://owaahh.com/sack-imperial-bank-epilogue>> Accessed 1 July 2017

⁴⁹ Ibid

acquaintances. This relationship was treated as a binding oath between the colluding parties as was revealed in an e-mail from a CBK official to Naeem Shah, the bank's former Head of Credit.⁵⁰

It is alleged that the immediate former Governor of CBK, Prof. Njuguna Ndung'u's visits to Dubai and his wife's visits to exclusive resorts in Thailand were sponsored by the bank⁵¹ thus indicating how the CBK terribly failed in its supervisory duties.⁵²

The late MD and his accomplices at Imperial Bank used a software reporting programme to conceal the fraudulent and illegal transactions. The software prevented unlawful, fictitious and fraudulent accounts from reflecting in the financial statements of the bank and it also suppressed the deposits to match the defrauded amounts thus misrepresenting true financial position the bank. All the while, the bank's Board was issued with annual audited accounts.⁵³

Audited accounts were also perused and doctored by CBK officials on instructions from Imperial Bank managers before being submitted to the Board.⁵⁴ In other occasions, officials of the bank deleted crucial accounting information. A good example is illustrated by an email of 24 October 2014 by the bank's then CFO instructing an employee not to capture some of the entries in the bank's classified loans list before including them in the records.⁵⁵

Further, investigations revealed unauthorised transactions which circumvented the credit approval processes. All these transactions were done under the full glare of CBK supervision.⁵⁶ The investigations further disclosed that approximately Kshs. 3 billion was moved to known accounts at third party banks. There were very many unauthorised cash withdrawals by the general managing directors.⁵⁷ In one instance, one W.E Tilley account's which had an overdraft of Kshs 446.9 million mysteriously reduced to Kshs 25.8 million.

The investigations unearthed several borrowers who never repaid their loans prior to the collapse of Imperial Bank. A list of top fifty (50) largest defaulting borrowers was generated and includes,

⁵⁰ Ibid

⁵¹ Ibid

⁵² Ibid

⁵³ Dominic Wabala (n99) above

⁵⁴ Owaah (n103) above

⁵⁵ Dominic Wabala, 'CBK, Imperial Bank staff colluded in fraud Report' *The Star* (12 February 2016)

⁵⁶ Owaahh (n103) above

⁵⁷ Ibid

among others, Adra International with a Kshs 1.8 billion loan, 1.4 billion loan for Vegpro (K), Kshs 1.2 billion from Italbuild Imports and Scarce Commodities Kshs 1.1 billion. Others include Kshs 1 billion debt for Samani Construction, Rods & Steel with Kshs 958 million debt, Kshs 763 million debt from SK Amin, Kshs 723million debt from Megha Industries (U), Coolxtreme with Kshs705 million debt, RM Patel & Partners with Kshs 676 million and Central Electricals International with Kshs 605 million debt.⁵⁸

2.2.4 The Collapse

The investigations further revealed a bizarre case where Kshs 3.058 billion was traced to have moved from one account to several others within an hour. The originating account was held in the name of Janmohamed, the bank's MD who had passed on by then⁵⁹ and the final account in the name of Hanscomb Management Limited, a briefcase company with no known physical address and which ran no current activities thus was wound up by the Registrar and stood dissolved in January 2002 while its bank account at Imperial Bank remained alive and active.⁶⁰

Kshs 76 billion moved through the Hanscomb account during its 14 years improper existence and even after Janmohammed's death. The records show that Kshs 3 Billion was withdrawn by Abdulmalek who had passed on. This transaction was approved by the group's MD, who had by then passed on. The amount was shared amongst the bank's top officials and their affiliates. There were also several accounts which had no names or existing companies backing them.

Imperial Bank declared customer deposits at Kshs 52 billion in its audited accounts, filed months before the MD died, which figure did not tally with the auditor's report which unearthed Kshs 33 billion more indicating that the bank's actual customer deposits stood at almost 86 billion shillings.⁶¹

⁵⁸ Ibid

⁵⁹ Ibid

⁶⁰ Ibid

⁶¹ Ibid

2.2.5 Imperial Bank becomes Insolvent

The CBK's failure to act on reports made on the unethical practices at the bank, including one in 2012 reporting that funds were being transferred to fictitious accounts monthly,⁶² encouraged and emboldened the perpetrators to continue fleecing depositors. However, it was not to be for long.

The coming in of Dr. Patrick Njoroge, as Governor of the CBK succeeding Prof. Njuguna Ndung'u, presented an unprecedented rules and rogue players in the banking industry were on limited lease of time. Upon discovering the unlawful practices by Dubai Bank and Imperial Bank the new CBK Governor, immediately placed the two banks into receivership and statutory management, respectively, thus casting the spotlight on his predecessor whom was then accused of having gone to bed with the banks' directors.⁶³

The CBK then sued the estate of the late MD and the shareholders for the recovery of 450 million dollars to pay the depositors. CBK accused the shareholders of recklessness and negligence in the discharge of their fiduciary duty and their utter disregard of the bank's precarious financial situation in awarding themselves huge amounts in dividends.⁶⁴

2.3 Conclusion

The case study conducted on the two banks demonstrates that they both collapsed due to corruption manifested by fraudulent, dubious and shady transactions. The said corruption thrived due to weak corporate governance structures that existed within these banks. The case study has also demonstrated that there was complicity on the part of regulator who failed to ensure compliance through proper supervision. There seems to have been improper interactions between the bank's officials and the regulator.

Weak corporate governance was evident in the following areas. Firstly, the board size, composition and remuneration. The performance and growth of a company are reliant on the Board in place hence the need to have the right size and composition. At the time of its collapse Dubai bank had only three directors as opposed to the required minimum of five directors thereby compromising its oversight and monitoring role. Imperial bank directors paid themselves huge dividends in total

⁶²Joshua Masinde Quartz et al, 'Exotic holidays, gifts and the \$380 million Fraud that brought down a Kenyan Bank' Yahoo Finance (16 December 2016) Accessed 1 July 2017

⁶³ Ibid

⁶⁴ Ibid

disregard of the bank's ailing financial status. They failed to first consider the performance of the bank before they paid themselves huge perks.

Secondly, conflict of interest was manifest in both banks. The Managing Director at Imperial bank, was the Founder, the Chairman to the Board as well as the Principal shareholder. A position he used to run a scheme of fraudulent and illegal disbursement of funds to the detriment of the bank. The Chairman to the Dubai bank was both an executive and a non-executive director of the Board. These scenarios create avenues for conflict of interest to thrive as too much control is left to person. In both cases we see companies, friends and relatives of the two Chairmen being the main beneficiaries of large questionable loans and credits and their involvement in conspiracies, fraud and theft of funds.

Thirdly, financial reporting, it is clear from the study above that both banks prepared inaccurate and unreliable reports which did not capture or reflect their true financial status. The said reports were submitted to the board and regulator. The forensic audit report on Imperial bank revealed that the bank had been cooking its books for a very long time. The said bank had a system in place that manipulated the figures to hide fictitious accounts and bad loans. Dubai bank also cooked its books of account by hiding substantial wealth that had been accumulated by its Chairman through irregular insider lending. Both banks did not make provisions as required for the non-performing loans.

Fourthly, transparency and disclosures; as a key principle of corporate governance transparency promotes success in any organization. Timely dissemination of accurate information to stakeholders helps in monitoring of the management of an organization. It was evident that the two banks were not transparent in their reporting. Dubai bank failed to report on insider lending deals by manipulating its books to under declare. Imperial bank on the other hand failed to disclose non-performing loans as well as insider lending.

CHAPTER THREE:LEGAL AND REGULATORY FRAMEWORK ON CORPORATE GOVERNANCE AND CORRUPTION IN KENYA

3.0 INTRODUCTION

The recent financial scandals and collapse of banks in Kenya clearly demonstrate how corruption is bedevilling our institutions. Kenyan banks have unfortunately been caught up in money laundering, perpetuating fraud and a conduit for bribery. Much of the evils bedevilling our banking sector has been highlighted in Chapter Two of this paper. Investigations into the collapse of these banks have revealed a number of contributory factors among them poor corporate governance, corruption and political interference.

Their failures can also be attributed to the inefficiency, inadequacy and shortcomings of the policy, legislative and regulatory framework governing banks. This Chapter examines the current policy legal and regulatory framework on corporate governance and corruption. It highlights and exposes the inadequacies in the current corporate governance mechanisms and structures. This Chapter also enables readers to appreciate the importance of good corporate governance in fighting graft. The chapter starts by analysing the existing policy, legislative, regulatory structures on corporate governance and corruption.

The anti-corruption regime in Kenya consists of several pieces of legislations and policies. Kenya's social economic development continue to suffer great challenges with corruption remaining arguably the greatest despite the existence of several policies and legislation to curb it.⁶⁵

3.1 Legal and Regulatory Framework on Corporate Governance

3.1.1 The Constitution

The Kenyan Constitution, 2010 stands supreme in the hierarchy of laws in the Republic of Kenya. It is binding on both levels of government and all state organs established therein or by any other written law and all persons.⁶⁶ The Kenyan Constitution under Article 2(6) provides that any treaty

⁶⁵ Fredrick Collins Omondi, 'Policies and Legal Framework on Anti-corruption in Kenya.' Available at <http://chs.uonbi.ac.ke/sites/default/files/chs/chs/Corruption%20Presentation%20final_CHS.pdf> Accessed 28 July 2018

⁶⁶ Article 2(1) of the Constitution of Kenya.

or convention which Kenya ratifies become part Kenyan laws. All international laws on corporate governance, therefore, which Kenya ratifies and adopts become part of its law. The Constitution in its spirit, seeks to promote good governance through transparency, effective leadership and integrity which in essence aims at promoting a corrupt free state. It provides for national values and principles of good governance⁶⁷ which binds all state officers, state organs, public officers and all persons whenever they apply or interpret the Constitution,⁶⁸ make or implement decisions touching on public policy.⁶⁹

The Constitution under Article 10⁷⁰ provides for principles to be applied by state officers and all persons while implementing public policy decisions. Accordingly, the term ‘all persons’ do refer to a natural or corporate person such as banks. Therefore, banks and specifically their management, are bound by this provision in the course of their dealings with the members of the public. The Constitution under Article 260 defines a “person” to include an association, a company or other body of persons whether incorporated or unincorporated.⁷¹ Reference is made to the well-known case of *Salomon v Salomon and Co Ltd* [1897] AC 22 which established a legal principle which has been accepted and followed consistently: a limited company is a legal person independent of its members.

Chapter Six of the Kenyan Constitution focuses on leadership and integrity. It requires state officers to be persons of integrity, who are accountable and responsible for their actions and decisions and to act objectively and impartially without any favouritism.

The Kenyan Constitution under Article 79 requires Parliament to establish the Ethics and Anti-Corruption Commission (EACC) to help implement Chapter Six of the Constitution. The Public Officer Ethics Act⁷² was enacted pursuant to Chapter Six of the Kenyan Constitution. Article 73(2) of the said Constitution provides for the principles of leadership and integrity which include: effective, efficient and economic use of resources; high standards of professional ethics; responsive, prompt, effective, impartial and equitable provision of services; involvement of the

⁶⁷ including good governance, integrity transparency and accountability under Article 10(2)(c)

⁶⁸ Article 10(1)(a)

⁶⁹ Article 10(1) (b)

⁷⁰ of the constitution

⁷¹ Article 260

⁷² Article 80

public participation in the process of making policy, transparency, accountability, and provisions of accurate and timely access to information.⁷³ Chapter Thirteen of the Constitution lays down the values and principles governing and guiding provision of public service⁷⁴ within the public sector.

Banks are in the business, among others, of taking deposits from members of the Public. As such, decisions of those in bank managerial positions have huge ramifications to public at large. This paper relates with the position in *Richardson and David Limited vs. Kenya Deposit Insurance Corporation & Another*.⁷⁵ In that case, Ogola J, eloquently stated that:

“A bank is a very important financial institution, and decisions concerning its operations should not appear to be made whimsically. Those decisions must be seen to be based on some policy principles which can be stated and dependent upon. This policy principle, when stated, will not only give assurance to the entity to be liquidated, its shareholders and depositors, but more important to the banking public”

However, most banks are run as private institutions. Critics have argued that extending principles of Chapter Six and Chapter Thirteen of the Constitution to banks is tantamount stretching the law too far. The Constitution specifically and deliberately makes reference to ‘state officers’ as those to be subjected to the principles highlighted in the two chapters. It defines a “state officer” as a person who holds a state office and proceeds to list what constitutes a state office. From the same definition, it is only rational to conclude that private sector organizations do not fall within the realm of Chapter six. The Constitution has not explicitly, in isolation and independently provided for corporate governance.

There is a bit of a lacuna in the law. There is a question on the applicability of Chapter Six and Thirteen of the Constitution. The question is whether these two chapters can be extended to private organizations such as banks. Banks are institutions whose operations have a huge bearing on the social-economic status of the people. Consequently, the Constitution ought to have at least included it while prescribing the subjects of Chapter Six and Thirteen.

⁷³ All these principles and values have been entrenched into different sections of the constitution and apply at all times especially in handling matters of public offices.

⁷⁴ Article 232

⁷⁵ [2015] eKLR

3.1.2 The Companies Act, 2015

The Companies Act, Cap 486, Laws of Kenya (Now Repealed) previously provided for corporate governance guidelines for Kenyan companies publicly listed. The said guidelines were enforced by the Capital Markets Authority (CMA). Cap 486 highly resembled the UK's Companies Act, 1948. Some have argued that it was a carbon copy of it. The repealed legislation notably provided for the directors duties which were based on common law. These duties were divided into the duty of care, skill and loyalty.⁷⁶ The duty of care and skill was an attempt to order the director's entrepreneurial side of activities while the duty of loyalty focused on good faith, avoiding conflicts of interest and suppressing managerial opportunism.⁷⁷

The Companies Act No. 17 of 2015 (The Act) repealed the Companies Act, Cap 486. It is current and is in touch with the market realities. This is the case as it takes into account the unique circumstances of Kenya's economic landscape. It is intent on streamlining the conduct of business in Kenya by facilitating efficient and effective market conditions so as to enhance the ease of doing business within Kenya. Its voluminous size is accounted for by the due consideration it takes on technological developments and sets out corresponding procedures to meet its ambitious goal – to enhance the ease of doing business. Additionally, it codifies principles of corporate governance thus giving a breath of life to these now-generally-accepted principles and thus creating a revolution within the sector and enhances the culture of corporate governance in most companies.

Kenyan companies are required to fully comply with the Act. The Act is both a consolidation of laws on companies in Kenya and a modernization of statute law on the subject.⁷⁸ This Act, unlike its predecessor, takes into account a wide array of corporate governance issues. The Act provides under Section 14⁷⁹ for the general duties of directors based on common law and equity.⁸⁰ Section

⁷⁶ Emma Bosibori Ogongo, “*Corporate Scandals: An Analysis of the Legal Framework of Corporate Governance in Kenya*”. A Thesis submitted to the Faculty of Law in partial fulfilment of the requirements for the conferment of Masters in Law, University of Nairobi.

⁷⁷ Douglas Y. Park, “Fiduciary duties of the Board of Directors: The Basics August 2011, available at <www.dyadvisors.com/2011/08/22/fiduciary-duties-of,> Accessed 31 July 2017.

⁷⁸ Richard Harney, ‘The New Companies Act 2015 Has Come into Operation In Kenya’ <<http://www.bowmanslaw.com/wp-content/uploads/2016/08/The-New-Companies-Act-2015-Has-Come-into-Operation-In-Kenya.pdf>> Accessed 27 July 2018

⁷⁹ of the Company Act, 2015

⁸⁰ Section 140 (3) of the Companies Act, 2015, Laws of Kenya.

143 of the Act requires that the actions of a director are in good faith and that they promote the success of the company for the benefit of all its shareholders.

The director is required, while making the decision, to consider how their decisions will in the long run impact the interests of the company, its employees, customers, suppliers and other stakeholders. The decision should also take into account environmental conservation, impact on the community, maintenance of a reputation for high standards and striking a fair balance between the shareholders' interest and of the directors.

The aforementioned provision shifts from the narrow view of a corporation as shareholder centred to the stakeholder perspective where the employees' interests are taken into consideration. This perspective is more inclusive and promotes good governance. The Act takes the view that, in a corporation, shareholders are the only stakeholders with an interest in the success of the corporation.

The Act⁸¹ requires a director to apply independent judgment and while doing so, to exercise diligence, skill and reasonable care.⁸² The director is expected to exercise the knowledge, skill and experience reasonably expected of a director based on objective test of a director's experience, skill and knowledge, which is a departure from the previous law which focused on a subjective test.⁸³ The Act under Section 146 concerns itself with conflict of interest and requires directors to avoid situations of conflict of interest, whether directly or indirectly.

In a bid to further good governance among companies, the Companies Act 2015, in Part X, provides for disqualification of directors. This part requires that a director's actions be within the law or else he or she may be disqualified for a certain period of time. Section 239 of the Act also provides for derivative actions which allows for any member of a company to commence proceedings on a company's behalf seeking relief for the company against the company's director or any other person. However, a member who wants to institute such an action must first apply for permission from the court to institute the claim. This provision now enables members of the

⁸¹ Section 144

⁸² Section 145

⁸³ Section 145

company to hold directors and the management team accountable unlike previously when an action against a director or other person could only be instituted in the name of the company.

The challenge, however, lies in the implementation of the Act. There is need to reform the institutions and bodies set up under the old Act. The Act is currently in the transition phase. Consequently, it is yet to achieve 100% implementation. There is need to conduct continuous training for the personnel at the Companies Registry to ensure effective administration of the Act. It is noteworthy that the Judiciary's role in interpretation of the Act is also important.

3.1.3 The Penal Code

The Penal Code⁸⁴ is the legislation that codifies actions considered to be criminal in nature. It criminalizes actions by directors that are considered to be criminal in nature. Some actions by stakeholders in the banking industry amount to criminal offences punishable under the penal code. A number of offences and their prescribed penalties include, among others:

- a) Knowingly giving false statements with the intention to defraud a company upon conviction face imprisonment of up to seven years.⁸⁵
- b) Offences such as theft and conspiracy to defraud committed under the corporate sector are also punishable under the Act.
- c) Concealment by a bank or other institution, of its true financial position is a felony,
- d) Banks or other financial institutions which hold a cheque that cannot be settled for the amount due thereon with an intention to hide their true financial position commit an offence,
- e) A bank or person who facilitates money transfer to a holder of false cheque with the intention to defraud commits an offence.⁸⁶

The enumerated penal provisions among others in the penal code, are meant to curb the vices such as concealment of financial information and the intention to defraud both of which violate principles of corporate governance. Previously, prosecution of corporate crimes was very difficult. Legal rights largely belonged to the company and not individual members. Shareholders,

⁸⁴ Chapter 63 Laws of Kenya

⁸⁵ Section 329 of the Penal Code, Cap 63, Laws of Kenya.

⁸⁶ Section 316B of the Penal Code

especially minority shareholders, would hardly bring an action against the company.⁸⁷ The Companies Act, 2015 has made it possible for minority shareholders to bring actions against directors. Specifically, offences such as theft and conspiracy to defraud can be brought against the directors of the companies.

3.1.4 The Capital Markets Act

The Capital Markets Authority (CMA) is established by The Capital Market Act Cap 485A⁸⁸ establishes the CMA.⁸⁹ The Act confers power on the CMA to set out guidelines meant to enhance corporate governance by companies that are publicly listed in Kenya. These companies are required to observe the CMA Guidelines.

As an independent government agency, the CMA, deals with licensing, supervising and monitoring market activities of institutions under it as the central depository and settlement system and stock exchange and of all other persons licensed under the Act. Guidelines on asset allocation provide the avenue for the CMA to regulate the financial services sector and Section 11 (1) (d) thereof provides for the protection of investor interests.

3.1.5 The Code of Corporate Governance Practices for Issuers of Securities to the Public 2015

The Code of Corporate Governance Practices for Issuers of Securities to the Public 2015 (Code of Corporate Governance) was developed by CMA to succeed the Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2002.

The said Code focuses on good corporate governance being integral to businesses and their dealings and culture and to this end therefore recommends certain structural and procedural mechanisms and principles that companies should adopt.⁹⁰

The Code requires listed companies to go beyond the minimum legislated provisions on corporate governance, comes with a paradigm shift from the rule based “Comply or Explain” approach to

⁸⁷ An exception to this is allowed where majority of the shares are controlled by those against whom relief is sought in particular where they have acted fraudulently or in excess of their powers.

⁸⁸ Sections 11(3)(v) and 12

⁸⁹ Chapter 5

⁹⁰ The Capital Markets Act, Cap 485A, The Code of Corporate Governance Practices for Issuers of Securities to the Public 2015, Gazette Notice No. 1420.

the principle based “Apply or Explain” approach.⁹¹ Under this Code, it is a requirement that the board of a listed company gives reasons, which are deemed satisfactory to the CMA, for non-compliance. However, there are provisions of the Code that are mandatory and which must be implemented by all listed companies.

The Code requires proper constitution of the board with members who have the appropriate knowledge, independence, appropriate skill balance and experience to ensure responsible, effective and efficient management of the company.

Various principles based on best practices are enumerated in the Code. The Code takes an interest on stakeholders. The code contains a whole chapter on stakeholder relations. It notes that stakeholders positively impact on the business strategy of a company and its long term growth shifting the attention away from shareholders. The Code also provides for ethical and social responsibilities which companies need to abide by in addition to their legal responsibilities. The Code requires companies to be good “corporate citizens” and establish a healthy ecosystem comprising the company and its social and natural environments.

The Code lists practices of good corporate governance which companies should adopted if intent on protecting and promoting shareholders’ and stakeholders’ interests while ensuring that companies have sustainable growth. While the Code is meant for listed companies, other companies may also adopt the principles contained therein.

3.1.6 Mwongozo- The Code of Governance for State Corporations

Mwongozo was issued in 2015 as part of the parastatals reform agenda aimed at ensuring sustainable, effective and efficient utilisation of public resources taking into account rising societal needs.⁹² It was developed so as to address challenges in the state corporations such as political interference and incompetence of the Board. The Code was developed to help entrench corporate governance best practices in state corporations.

Mwongozo addresses matters touching on the effectiveness of the board, good corporate citizenship, accountability, internal controls, risk management, transparency and disclosure, and

⁹¹ Ibid.

⁹² Mwongozo, The Code of Governance for State Corporations, 2015 at p.7

ethical leadership.⁹³ While state corporations in Kenya have over the years been written off due to corruption and mismanagement, it is hoped that the Code will usher in a new dawn on how governance matters are handled by state corporations. The Code's provisions are almost similar to those of the Code of Corporate Governance Practices for Issuers of Securities to the Public 2015 which is tailor made for parastatals. Non- state owned corporations can only adopt the code and not be compelled to do so. The said corporations can only add Mwongozo to their own corporate governance principles and practices.

3.1.7 International Treaties and Conventions

3.1.7.1 The OECD Principles of Corporate Governance, 2015

A review of the Principles of Corporate Governance developed by the OECD in 1999 gave rise to the 2015 OECD Principles of Corporate Governance. It is noted by the Secretary General, OECD that the principles are about "inclusiveness." He states as follows; *"Today, millions of households around the world have their savings in the stock market, directly or indirectly. And publicly listed companies provide for more than 200 million jobs."*⁹⁴

The rights of the stakeholders and their ability to enhance corporate wealth creation have been taken into account by these principles. They are divided into six chapters, covering:

- a) An effective framework on corporate governance.
- b) Key ownership functions, shareholders' rights and their equitable treatment..
- c) Institutional investors, stock markets and other intermediaries.
- d) The role of stakeholders in corporate governance.
- e) Transparency and disclosure.
- f) The Boards responsibilities.

The intention is for the principles to act as a broad guidance to nations. However, the private sector and governments are encouraged to develop detailed provisions, whether mandatory or voluntary, taking into account the uniqueness of each country or institution. While these principles are tailored or deemed to be more appropriate for larger companies, smaller companies or those with

⁹³ Ibid.

⁹⁴ The OECD Principles of Corporate Governance, 2015, "Note by the OECD Secretary-General" at p.3

no publicly listed shares may borrow the principles that are applicable to them. The principles recognise employees' interests and those of other stakeholders in the success of the company. They are developed with the hindsight that economic growth will ultimately be boosted by good corporate governance. This is in view of the fact that good corporate governance practices attract investors and help in boosting capital for a company.

The Principles, however, are neither binding nor intended to be adopted hook, line and sinker as national legislation but to be used rather as pointers of objectives and suggestions for several means of achieving those objectives. As a point of reference, the Principles can inform the policy making process in the establishment of robust and customised legal and regulatory frameworks on corporate governance taking into account unique social, cultural, legal and economic circumstances.⁹⁵

Equally, good corporate governance principles are neither mandatory nor prescriptive but rather designed as models for guiding companies to independently craft unique codes of best practice taking into account their corporate cultures among others.

3.2 Legal and Regulatory Framework on Corruption

3.2.1 The Constitution of Kenya, 2010

International law on corruption becomes part of Kenyan law courtesy of Article 2(6) of the Constitution. One such international law is the United Nations Convention against Corruption which Kenya has ratified and adopted effectively forming part of Kenyan law. The spirit of the Constitution speaks against corruption. At Article 79, the Constitution tasks Parliament with establishing the Ethics and Anti-Corruption Commission (EACC) mandated, among others, with implementing of Chapter Six of the Constitution and the provisions of the Ethics and Anti-Corruption Commission Act, 2011 was enacted by Parliament, enacted pursuant to the above cited provision.

3.2.2 Ethics and Anti-corruption Commission Act (EACA), 2011

As indicated earlier, the EACA was enacted in 2011 pursuant to Article 79 of the Constitution of Kenya. EACC is established under Section 3 and its functions are outlined in Section 11(1). These

⁹⁵ OECD Principles of Corporate Governance at p.13

function add to the general functions set out by the Constitution under Article 252. The functions include:

- a) Developing and promoting best practices and standards in anti-corruption and integrity.
- b) Establish a code of ethics for state officers.
- c) Working with public and state offices to develop and promote integrity and anti-corruption standards and best practices.
- d) Receiving reports on public officers who breach of the code of ethics.
- e) Investigate and make recommendations to the DPP the prosecution of violations of codes of ethics or any acts of corruption or any offences under the Act or any written law giving effect to Chapter Six of the Constitution or enacted pursuant thereof.
- f) Recommending disciplinary action against public officers or state officers who allegedly engage in unethical conduct.
- g) Overseeing the enforcement of codes of ethics governing public officers.
- h) Offer advice to any person on its own initiative or on any matter falling within its functions.
- i) Raising public awareness and educating the public on ethical issues and the dangers of corruption and where necessary enlisting and fostering public support in combating corruption.
- j) Instituting and conducting court proceedings for recovery, protection, freezing or confiscating of public assets.⁹⁶

The Act also sets out the qualification requirement for the appointment of the Commission's chairperson and members of the Commission and the procedures of carrying out such appointments.⁹⁷ Funding of the Commission which includes money granted by Parliament, donations and grants to the Commission and any other funding that accrues to the Commission when carrying out its functions are dealt in detail under Part III of the Act.⁹⁸

Section 27 of the Act requires the Commission to prepare annual reports to be presented to the National Assembly and the President. The annual reports should contain the Commission's financial statements, impact of exercise of its mandate, description of its activities, it's

⁹⁶ Section 11(1) of the Ethics and Anti-Corruption Commission Act, 2011, Laws of Kenya, Government Printers, Nairobi.

⁹⁷ Section 4 to 10 of the EACA.

⁹⁸ Section 22 of the EACA.

recommendations to state agencies and departments and noting whether any action taken and any challenges faced by the Commission in executing its constitutional and statutory mandate. The report is also to be published and made public for the citizens. Despite the Commission being operational since 2011, there has been little change in the terrain of corruption in Kenya.⁹⁹ The Commission's mandate is, to a large extent, restricted to corruption in public offices or to the extent that they relate to private organization. This has given room for corruption to go unchecked in the private sphere.

3.2.3 Anti-Corruption and Economic Crimes Act, 2003 (ACECA)

The substantive law on anti-corruption is embodied in the Anti-Corruption and Economic Crimes Act. ACECA offers some of the key approaches that the government should take in fighting corruption. Specifically, it provides for guidelines on how to investigate, prosecute, prevent, educate and recover assets.¹⁰⁰ Corruption is defined by the ACECA as an offence involving embezzlement and misappropriation of public funds, bribery, abuse of office, breach of trust, fraud, or tax offences or offences under applicable elections laws.¹⁰¹

The Chief Justice, may, pursuant to Section 3 of the Act appoint special magistrates sufficient to handle corruption and economic offences. The courts may offer full pardon to any accused person in exchange for information on the activities of any accomplice. However, despite the existence of these special courts, their effectiveness is yet to be seen. Equally, there has been little improvement on how cases that touch on corruption are handled even with the introduction of these special corruption courts. There has been no effective prosecution and conviction of corruption related cases. Furthermore, there has been no efficiency in disposing of corruption related cases in Kenya.¹⁰²

The Commission may require a suspect to furnish details of property suspected to be acquired through corruption.¹⁰³ Section 28 of the Act requires the production of documents required for

⁹⁹ Dr Njaramba Gichuki, "Dismantling the Corruption Sector in Kenya: Righting the Wrongs in the Institutional Framework" (2016). A Paper presented at the Law Society of Kenya Annual Conference held on 17 to 21 August 2016 at the Leisure Lodge Beach and Golf Resort, Kwale County.

¹⁰⁰ Ibid.

¹⁰¹ Section 2(1), Anti-Corruption and Economic Crimes Act, 2003.

¹⁰² Dr Njaramba Gichuki (n63) above

¹⁰³ Section 26 of the ACECA.

investigation or provision of information on documents used in investigation.¹⁰⁴ Given the sensitivity of corruption incidences, the Act under Section 65 provides for protection of informers and other persons who aid the EACC in its investigation of corruption related offences. The Act requires the protection of the identities of informers and whistle-blowers requiring that their names and other identifiable information be expunged from public records and be free of scrutiny in court save where doing so helps achieve the ends of justice. The Act provides for immunity of informers who it is established that while acting in good faith, honestly believed that the information was true at the time of giving it.¹⁰⁵

3.2.4 Public Officers Ethics Act (POEA)

The Code of Conduct and Ethics for public officers was established under Section 7 of POEA. The said Code seeks to advance the ethical conduct of public officers. The Code makes provisions that cover, among others, political neutrality, professionalism, rule of law, unjust enrichment, conduct of private affairs, conflict of interest, misleading the public, nepotism, sexual harassment and selection of public officers.¹⁰⁶

The Act also provides a guidelines that require declaration of income and liabilities by public officers for accountability purposes.¹⁰⁷ It empowers the Commission (EACC), under Section 25 thereof, to commence investigations against a public officer and to determine if there have breached the code, and, if there is breach, recommend appropriate disciplinary action pursuant to Section 36 without prejudice to any civil or criminal suit which may be instituted upon conclusion of investigations. Notably, this Act applies only to public officers and not those in the private sector.

3.2.5 Bribery Act 2016

The Bribery Act No. 47 of 2016¹⁰⁸ has far reaching implications on Kenyan businesses e.g. banks and foreign organizations that conduct business in Kenya. The Act came in the wake of changes

¹⁰⁴ Article 50 of the Constitution of Kenya.

¹⁰⁵ Section 65 of the ACECA.

¹⁰⁶ Sections 9-25 of the Public Officers Ethics Act.

¹⁰⁷ Part IV of the Public Officers Ethics Act.

¹⁰⁸ Section 1 of the Bribery Act

to the EACC in a bid for a national and cross-sector battle on corruption. The Act provides the framework to prevent, investigate and punish bribery and related offences in Kenya.¹⁰⁹

The Act applies to individuals, public officers and private entities¹¹⁰ and principally criminalises the giving or receiving of a bribe. Responsibilities imposed on the individuals and the private entities by the law was previously insignificant. Conversely, the present law marks a paradigm shift as it imposes express duties on private entities and individuals to facilitate the enforcement of the Act and creating offences in the event of non-adherence.¹¹¹

Section 5 of the Act prescribes actions which can be termed as bribe¹¹² to cover instances where; one makes a promise, offers or gives a financial or any advantage the another with the knowingly or believing that receipt the said advantage, financial or otherwise, will require that an improper a relevant function or activity to be done improperly. It also defines the offence of receiving a bribe¹¹³ to constitute the receipt or agreement to receive a bribe with the intention to improperly perform an activity or function.

The Bribery Act is to be applauded for its extra-territorial jurisdiction where acts of bribery committed outside Kenya are treated to have been committed in Kenya. It cover bribery acts committed while in or out of the country by Kenyan citizens, public and state officers, and public and private entities and their associates who include companies – subsidiary or otherwise, agents, employees, officers, among others and also covers acts of bribery targeted at a foreign public official.

Section 9 and Part III of the Act outline requirements for averting bribery that must be put in place by private entities and non-compliance, whether by consent or connivance of the directors or senior officers of a private entity, results in an offence punishable by law. The Act additionally provides a framework for accountability and effective co-ordination while dealing with the fight against acts of bribery. The co-ordination is not entirely optional as the Act imposes statutory duty on persons. One such legal obligation imposed on a person in authority within a private entity is the

¹⁰⁹ Bowman's Law: *The Kenya Bribery Act, 2016* <<https://www.bowmanslaw.com/legal-updates/bribery-act-2016-kenya>> Accessed 25 July 2018

¹¹⁰ Section 4 of the Act

¹¹¹ Bowman's Law (n73) above

¹¹² Within part ii of the Act

¹¹³ Section 6 of the Act

duty to report a bribery act within 24 hours of becoming aware of it. The Act is dynamic in its definition and demarcation of offences. It extends its scope beyond the mere act of taking a bribe to false accounting reports of any private entity aimed at hiding property acquired through corrupt dealings. Section 10 of the Act, makes a private entity liable for the acts of bribery of its associate thus providing a deterrent measure to both juristic and natural persons.

The Act recognises that public or private entities and other interested persons may need guidance in the development of measures to prevent corruption and therefore enjoins EACC and the relevant Cabinet Secretary, as required by Section 12 of the Act, to consult and publish guidelines to aid public and private entities to prepare these procedures. The reasoning behind incorporating the private sector as stakeholders in battling corruption is premised on the view that the government is a major consumer of services from the private sector and the move therefore is aimed at averting corruption and bribery at source.

Just like officials of private entities are required to report corruption or suspicion thereof, to the EACC within 24 hours awareness, knowledge or suspicion of corruption or bribery incidence, Section 14 of the Act imposes an equivalent legal obligation on public officers and state officers, among others. It is an offence to fail to report a bribery incident. The Act provides for several penalties for the offences created therein, ranging from, fines of up to five million, imprisonment for up to ten years, a five times the benefit acquired mandatory fine or of incurred loss as a result of the bribery, among others.

Section 18(7) of the Act lists additional measures which include seizure of properties belonging to a person or company suspected of benefitting from a bribe, demand for the person to pay back the equivalent of the amount or value of advantage received or loss incurred by the other party, disbarment from participating in government procurement or tendering, where the director of a company in default was the defaulter, he is disqualified from being any company's director and from any state or public office position for a ten (10) years period on the minimum.

The contribution of whistle blowers and witnesses in the fight against corruption is highly appreciated by this Act and as such provides for their protection under Section 21. A fine of Shillings 1 million or a one year imprisonment term is imposed on any person found guilty of

interfering, in any of the listed manners. Although a major highlight of the Act is the introduction of corporate criminal responsibility in the private sector, its effectiveness is yet to be felt.

The enactment of the Bribery Act to combat private sector corruption is a positive step towards reduction of corruption in Kenya. The implementation of anti-bribery laws is, however, largely dependent on the cooperation and good will of all the stakeholders.¹¹⁴

3.2.6 International Instruments on Corruption

Anti-corruption is a global agenda which has yielded the establishment of international and regional regimes to fight the vice.¹¹⁵

3.2.7 OECD Anti-Bribery Convention

The above Convention¹¹⁶ targets corruption reduction in member states within the developing countries category. The Convention imposes sanctions on business transactions within the member states that are tainted with corruption and are international in nature even as it seeks to ensure fairness and equity within the international business environment. Giving or offering of bribes is an offence under the Convention while the receipt or soliciting of a bribe is not.

The importance of the Convention is evidenced in a 2017 study which established that corporations carrying out business within non-member states were more prone to corruption than multinational corporations found within states with membership to the said Convention.

Member states are responsible for the domestication of the Convention which requires them to have national laws that make bribing of foreign public officials a criminal act. They are also tasked with the implementation of those laws since the OECD's role and authority is limited to monitoring the implementation of the Convention through its Working Group on Bribery and not the Convention's actual implementation.

3.2.8 The United Nations Convention against Corruption (UNCAC)

UNCAC which is referred to as Principle 10 within the UN system, was adopted in the year 2004 and operationalised in the year 2005. It seeks to fight corruption globally by attacking its several forms, including bribery and extortion. The Convention aims at increased transparency in global

¹¹⁴ Africa Legal Consulting team "www.africalegalconsult.com"

¹¹⁵ Fredrick Collins (n29) above

¹¹⁶ Official Convention on Combating Bribery of Foreign Public Officials in International Business Transactions

economy and requires member states to craft concrete programmes and policies addressing corruption and at the same time requires implementation of the Anti-Corruption Call to Action by governments and businesses.

UNCAC provides for bribery within the private sector and states within the convention are required to craft measures, whether legislative or otherwise, for the criminalisation of corrupt acts perpetrated during commercial, financial or economic transactions and for the protection of whistle blowers.

Kenya has to a large extent complied with Chapter 3 of the Convention by criminalising most of the activities categorized in the Convention as corruption.

3.2.9 Other Conventions

- a) The African Convention on Preventing and Combating Corruption which was ratified on 3 July 2007 and became operational on 5 August 2006.
- b) The United Nations Declaration Against Corruption and Bribery in the International Commercial Transactions.
- c) The Organization for Economic Co-operation and Development (OECD) Protocol to combat bribery by foreign public officials in international business transactions.

3.2.10 Other important sources of policies and laws on corruption

- a) The United Nations Handbook on Practical Anti-Corruption Measures – for Prosecutors and Investigators.
- b) The United Nations Guide for Anti-Corruption Policies. This guide targets senior policy makers and political officials. It gives a description of the integral elements of anticorruption, and a generally outlines how corruption is a menace.
- c) The General UN Anti-Corruption Toolkit.
- d) The Compendium of International Legal Instruments on Corruption.

3.3 Strong Corporate Governance as a tool to curb corruption

Corruption dangerously drains trust the public and the legitimacy of institutions in all sectors leaving a devastating toll to a national economy especially when foreign investor confidence and trust suffers the revelation of systemic corruption thus effectively choking international capital flows.

Corruption is no respecter of the size or types of business organizations. It can crush a firm and its ripple effect on the firm's stakeholders' livelihoods which are, invariably, pegged on the firm's financial successes¹¹⁷ and Kenya just like other countries is no exception.

The establishment of strong and good corporate governance is an important method of tackling corruption in financial entities such as banks since it not only ensures sustainability, improved access to capital and enhanced efficiency but is also proving effective in the anti-corruption movement.

Good corporate governance destroys the environment where corruption thrives in. Increased accountability and transparency in decision making and enforcing thereof makes the giving, receipt and concealment of bribes problematic.

Good ethics feed into, as well as feed from, good corporate governance. Ethical behaviour of a company forms the cornerstone to good corporate governance and as well as it creates an environment where the practice of good corporate governance thrives since ethics determine, to a large extent, how a company transacts its businesses. A firm with an ethical foundation would have few corruption cases.¹¹⁸

Since disclosure, accountability and transparency arise from the internal controls introduced by corporate governance, fusing this with firm's leadership's support and ethical codes of conduct result in a hybrid tool for risk mitigation which can translate to tangible benefit to the firm.

A study by Deutsche Bank on the S&P 500 firms conducted over a period of two years and a similar one conducted by Harvard and Wharton on 1,500 U.S. based firms both found that companies that practised good corporate governance outdid the ones that had poor corporate governance in relation to their general performance, profitability and growth. The former study found the difference to stand at about 19 percent.

Good governance affects a company's long run performance as well as that of its stock returns thus poor corporate governance leads to dismally performing stocks that lower returns to the

¹¹⁷ John D. Sullivan and Andrew Wilson; ' *The role of Corporate Governance in fighting Corruption*' Available at <https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/finance/role_corporate_governance_sullivan_eng.pdf> Accessed on 25 September 2018

¹¹⁸ Ibid

shareholders and a risk to their investments while those with good practices in corporate governance posted greater returns on investments and the cost of equity capital was lower.¹¹⁹

The responsibility of cultivating ethical corporate culture rests on a firm's senior executives and presents the firm with a unique opportunity to become a role model and a trailblazer to industry peers, competitors and private sector generally who then become the firm's public accountability partners helping the firm to remain evermore grounded on its corporate ethical culture.

Internally, the senior management's commitment to anti-corruption policies allows the firm's ethical culture to thrive and provide validation throughout the company thus further strengthening the firm's reputation and identity as one concerned not with compliance issues but rather doing business right at the cost of losing business opportunities than compromising on its values.

A company committed to fostering corporate ethical culture needs to develop a comprehensive ethics policy deeply and neatly woven into its business strategy, which will provide internal checks and balances as well as corporate moral compass to aid the firm safely navigate the corporate corruption mine field and stay aligned to its concrete ethical standards and good corporate governance.¹²⁰

3.4 Conclusion

A review of the existing laws shows that corporate governance best practices have been adequately provided for. However, as demonstrated by the case study in chapter two of this study, banks have not embraced these best practices hence the weak corporate governance structures in place. The question that begs an answer is why banks continue to collapse yet there are adequate laws in place. This calls into question the role of CBK as the regulator in enforcement of these laws. There is need for regulatory reforms to ensure that CBK effectively and promptly implements the laws.

¹¹⁹ Ibid

¹²⁰ Ibid

CHAPTER FOUR: COMPARATIVE ANALYSIS OF UNITED STATES OF AMERICA AND SOUTH AFRICA: LESSONS LEARNT FROM OTHER JURISDICTIONS

4.0 INTRODUCTION

This chapter conducts a comparative review of mechanisms and structures on Corporate in the United States of America (US) and South Africa (SA). It highlights the successes and the failures in those countries as well as the challenges experienced during the implementing corporate governance. Of greatest importance, however, are the lessons to be learnt.

It proceeds to demonstrate how corporate governance has been utilized as a mechanism to strengthen systems in financial institutions and draws best practices in corporate governance. Corporate governance structures in the US, its successes and failures form the first part of this chapter while the second part focus on the South Africa counterpart.

Banks around the world are increasingly facing challenges of bribery and corruption. This research tries to find out the progress, steps, and responses employed in tackling these challenges. It specifically focusses on how the US and SA have implemented corporate governance mechanisms and structures.

4.1 Corporate Governance Systems

Ownership degrees and control of firms by shareholders is a major distinguishing factor of corporate governance system in different countries. Corporate governance systems with ownership that is widely dispersed, also known as outsider systems, such as that evidenced in the US experiences conflict of interest between the weak and widely-dispersed shareholders on one side and strong managers on the other side.

Insider systems, on the other hand, tilt toward the concentration of ownership or control, with Germany and Japan as its examples. In insider systems, the conflicting interests are those of the weak minority shareholders versus that of the controlling shareholders or block holders.¹²¹

¹²¹ Maria Maher and Thomas Andersson; *Corporate Governance: Effects on Firm Performance and Economic Growth*; OECD 1999 Available at <<https://www.oecd.org/sti/ind/2090569.pdf>> Accessed 25 September 2018

4.2 The United States of America

4.2.1 Corporate Governance Structure

The US corporate governance system is an “*Anglo-American model*” or “*the unitary system*” emphasising on the shareholders’ interests. This system is characterised by a one-tier Board of Directors structure with a greater majority of shareholders’ elected as independent directors who hold key positions like the compensation and audit committees. While it has been the norm in the US to have the position of CEO and Chairman of the Board held by one individual – considered a poor corporate governance practice, the number of firms presently sticking to this norm is in the decline.¹²²

State-based corporate law and federal securities laws comprise the basic legal structure of the US Corporate law with the latter focusing on the trading of securities while the former directly governs corporations.

Many states in the US have incorporated the Model Business Corporation Act has been adopted by many US States, however the Delaware General Corporation Law remains dominant for publicly traded corporations since majority of publicly traded corporations continue to prefer the Delaware State. The corporate charter and the corporate by-laws constitute individual rules for corporations. While shareholders can initiate changes to the corporate by laws they cannot do so in the corporate charter.

Shareholder wealth maximization principles underlie the US corporate governance system and the governing bodies include: Securities & Exchange Commission (SEC), Sarbanes-Oxley Act of 2002 (SOX) and the NASDAQ, NYSE stock exchanges guidelines etc. Court judgments are also relevant in various States since US corporations are registered in particular States.¹²³

4.2.1.1 Corporate System

The US Corporate governance system seeks to safeguard the shareholders’ interests and to ensure a reduction in the agency cost accruing from separation of ownership through combined multifaceted legal and institutional mechanisms. Some of these mechanisms are concerned with

¹²² Corporate Governance; Wikipedia <https://en.wikipedia.org/wiki/Corporate_governance> Accessed 29 August 2018.

¹²³ Sheeraz Raza; *Corporate Governance: USA vs Europe*; VW Business of 7 January 2013

increased to timely access to accurate information, empowering shareholders to monitor the actions of the managers thus enhancing market discipline. Others impose liability on the agents and penalise them in the event of conflict of interest while others aim at incentivising managers and other officers to align their interests with those of the shareholders.¹²⁴

4.2.1.2 Federal System Laws

Federal securities laws provide for disclosure and transparency and allows a shareholder to institute a suit against a manager involved in fraudulent activities. A proxy voting system is also provide for, which though it may be expensive for shareholders with small stake in the company, empowers shareholders to impose their collective will on significant and relevant changes or operations in the company including the election of corporate directors.¹²⁵

4.2.1.3 Corporate Law

The second line of defence lies in corporate law. Corporations' perpetual life, governance structure and shareholders, directors and managers' rights and duties derive from state law and the certificate of incorporation. Directors' rights and duties, especially duties of candour, loyalty and duty of care, have, overtime, been held by courts to strengthen the directors' fiduciary duties to shareholders and their violations give rise to suits against managers and directors.

The several obligations imposed on directors and managers and the penalisation of breaches thereof demonstrate the attempt of State corporate law to ensure that the interests of managers and directors are well aligned with the interests of the shareholders.

4.2.1.4 Executive Compensation.

Incentive compensation structures, for both managers and directors, aligned with shareholders' interests may be employed on the election of shareholders and directors. The 1990's saw the rise of equity-based pay where the executive compensation was tied to performance of a company's stock. Managers, in this case were either granted restricted stock or stock options. The dramatic increase in equity based pay saw an increase in average CEO pay by \$11.2 million 1992 to 2000

¹²⁴ Franklin R. Edwards; *"U.S. Corporate Governance: What Went Wrong and Can It Be Fixed?"*

¹²⁵ Ibid

representing an increase of 300% while the value of stock options increased by about 800% over the same period of time, that is from \$800,000 to nearly \$7.2 million.

94 percent of S&P 500 companies had by 1999 joined the wave were granting their top executives stock options with total CEO compensation standing at 47 percent as a broad range of executives and employees benefited from this system equity-based pay in sharp contradistinction with other countries' lower executive pay packages.

Corporations' stakeholders, broadly categorised as "gatekeepers" and "hostile takeovers" supplement the statute backed governance mechanisms. The gatekeepers look out for the shareholders' interest as they monitor corporations and corporate insiders. They scrutinise corporate reporting to certify their accuracy as well as audit the legality of corporate behaviour.

The gatekeepers, are skilled and independent professionals interposed by law or market conventions between investors and the corporation from where they perform their certification function. Gatekeepers include, *inter alia*, lawyers, underwriters, auditors, securities analysts and credit rating agencies.

Conventional theory posits that gatekeepers can be relied upon to execute their functions effectively and honestly based on their independence and desire to build and maintain their credibility and reputation since their business ride on these. The theory further argues that in addition to these positive incentives, the negative incentive – threat of private litigation and the attendant consequences helps gatekeepers to steer clear of reckless or fraudulent behaviour.

Whenever corporate governance mechanisms fail and the management is hopelessly incompetent, the markets ultimate response comes in the form of hostile takeovers. Theoretically, they involve the change of guard by bringing in new and capable managers to increase stockholder value, and incorporate good corporate governance mechanisms aligned with the shareholders' interests while taking into account the managers' interests as well and seeking to align them with those of the shareholders through such incentives as compensation schemes.

While hostile takeovers prove integral in an effective corporate governance system, they are not only a crude mechanism for checking incompetence and fraud but also costly and should be

considered as a last resort where the agency costs are high. Nonetheless, lazy and inept managers are likely to be jerked by the very threat of a hostile takeover thus proving to be a significant deterrent.

4.2.1.5 Corporate Scandals

The U.S. economy experienced a wake of corporate scandals in 2001 which saw diminishing confidence in the US's business system while putting the effectiveness of US corporate governance in doubt. The companies involved in these scandals, included, among others, HealthSouth, Enron, Tyco, WorldCom and Adelphia. The pervasiveness of these scandals suggest a low uptake of corporate governance by US companies and a massive failure by the US in monitoring and enforcing corporate governance in its companies.

Effective corporate governance is proportionate to the public confidence in corporations. Excessive executive pay in light of market realities and performance of individual corporations is a major cause of public distrust. The \$706 million compensation from stock options to Oracle's CEO, Larry Ellison, in 2001 while the company sputtered and its stock fell precipitously and the revelation of GE's former CEO Jack Welch huge perks reinforced the growing distrust in corporate managers. The revelation of the fraud perpetrated by the Tenet Healthcare and its CEO, Jeffrey Barbakow who made \$190 million in the fiscal year ending mid-2002 while the firm's earnings derived from a massive Medicare fraud could not have come at a worse period of time.

The last straw in this streak of scandals involved Dick Grasso, the CEO to the New York Stock Exchange. NYSE found itself on the spot light and its governance structure question following the disclosure of its CEO's lofty compensation his subsequent forced resignation thus betraying the whole role played by NYSE which is otherwise tasked with the determination and regulation of corporate governance standards for major corporations. Recurring incidences of non-disclosure and opaqueness by management of corporations have contributed to the high levels of public distrust.

The United States has largely succeeded in incorporating good corporate governance in its systems despite the challenges it has and continues to face.

4.2.2 Corporate Governance Challenges experienced in the US

Despite having a multifaceted corporate governance framework entail accounting rules for transparency and disclosure, securities and legal, the US, like other countries, struggles with its corporate governance. Yet, the question remains how it is that this framework proved ineffective in tackling the US corporate scandals involving mismanagement and corporate corruption?¹²⁶

Lack of rigorous implementation of the corporate governance framework, whether real or perceived, holds the key to the US broken corporate governance record despite the existence of a multifaceted corporate governance framework. The reasons behind this absence of rigor, include, among others:

- a) Centralisation of power within the top level of management;
- b) Absence of qualitative and quantitative personnel within agencies such as the Internal Revenue Service (IRS), Securities and Exchange Commission (SEC) and the Federal Reserve (FR), and others;
- c) Complacent professional organizations charged with the self-regulation of their respective professional bodies, such as the Public Company Accounting Oversight Board (PCAOB);
- d) The prosecutors lacking the necessary training, expertise and willingness to prosecute the crimes brought to their attention in an efficiently and timely manner;
- e) Disagreements between the representatives of the white crime delinquents and the regulators on the governing principles;
- f) The existence of well-designed loopholes sanctioned by the Congress at the behest of lobbyists.¹²⁷

The US Corporate scandals and the subsequent collapse of several companies involved therein, like Enron and MCI Inc (formerly WorldCom) whose collapse was directly attributable to bad corporate governance provided the US with the impetus for good corporate governance which

¹²⁶ Ibid

¹²⁷ Lessambo, “*The International Corporate Governance System*” © Felix I. Lessambo 2014

subsequently birthed the Sarbanes-Oxley Act in 2002, being a U.S. federal law aimed at restoring confidence in the public on matters corporate governance.¹²⁸

4.2.3 The Sarbanes-Oxley Act

Enacted in the wake of scandals in the US corporate sector, the Sarbanes-Oxley Act of 2002 required, among others:

- a) The Public Company Accounting Oversight Board (PCAOB) was established to regulate auditors and their profession.
- b) Companies' financial statements be attested by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO).
- c) Independent members be enlisted into Board Audit Committees.
- d) External audit firms to replace their lead partner every 5 years and desist from providing certain types of consulting services.

The Act further regulates conflict of interest, which was previously unaddressed and involved all forms of conflict of interest between provision of lucrative consulting services and an independent opinion, on the reliability and accuracy of financial statements.¹²⁹ The Act addresses this expressly by prohibiting an audit firm from auditing a company where any of the specified senior management personnel worked for the auditing firm in the past year.

4.2.4 Recent Developments

The evolving corporate governance sphere has seen enhanced efforts in the recent past to address corporate governance challenges in the U.S. The Bill, Accountable Capitalism Act, proposed by U.S. Senator Elizabeth Warren of Massachusetts, seeks to encourage creation of corporate charters by large companies as well as consider the interests of other stakeholders such as customers, workers and communities in addition to shareholders. It also seeks to ensure that employees elect 40 percent of the directors.

¹²⁸ Corporate Governance from Wikipedia <https://en.wikipedia.org/wiki/Corporate_governance> Accessed 4 September 2018

¹²⁹ https://en.wikipedia.org/wiki/Corporate_governance Accessed 4 September 2018

The Bill, borrows in part from the German co-determination system and is informed by the stakeholder theory. Warren argues that when employees are treated as vital stakeholders of the companies that employ them, the community will be better served. This is further supported by the proposition that employees have a right to elect their own representatives a provision which will translate to more power and money for them.¹³⁰

There exists no standard model on good corporate governance and neither the insider nor the outsider system is perfect as they both have their unique different economic implications, weaknesses and strengths and their effectiveness are influenced by differences in countries' legal and regulatory frameworks, historical and cultural factors thus it is difficult to identify what constitutes good corporate governance practice within a given set of circumstances. Thus, it is important to investigate the underlying conditions under which the strengths and weaknesses of a corporate governance system manifest in.¹³¹

4.3 South Africa

4.3.1 Introduction

South Africa stands apart from most African countries. In addition to possessing a financial and corporate regulatory structure that is sound, it is notably ranked as the sixth country in the world, to issue a code of good corporate governance, and definitely the first developing country.¹³² Traditionally, the South Africa corporate governance is founded on the shareholder value approach requiring directors to run a company in the best interests the all stakeholders.¹³³

4.3.2 Corporate Governance Reforms

South Africa's extensive domestic reforms on social, economic and political issues in the late 1980s and early 1990s in an attempt to improve the governance of companies, coincided with an international wave that sought to improve the efficiency of corporate governance structures

¹³⁰ Noah Smith; "Imagine if shareholders dint come first" in Bloomberg Opinion; Politics and Policy" 29 August 2018

¹³¹ Maria Maher (n120) above

¹³² Collins Gyakari Ntim, "Internal Corporate Governance Structures and Firm Financial Performance: Evidence from South African Listed Firms" A research Submitted in Fulfilment of the Requirements for the Degree of Doctor of Philosophy in Finance, University of Glasgow.

¹³³ Linda Muswaka, 'Corporate Governance under the South African Companies Act: A Critique' Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2184678> Accessed 26 August 2018

worldwide. This and the publication of cases covering the collapses of major corporations suspected to have been brought to their knees by poor corporate governance practices, gave South Africa enhanced impetus to see the reforms through.

Consequently, the King Committee on Corporate Governance, named after its Chair, Mervyn King, was formed in 1992, as a voluntary initiative to enhance the standards of corporate governance in South Africa. The above move was instigated by the Southern Africa Institute of Directors. Subsequently, the King Committee prepared a report and published it in November 1994. The King Report adopted several standards and principles of corporate governance then in existence and was, to a large extent, informed by the 1992 Cadbury Report.

Therefore, the King's Report principally adopted a one-tier board of directors made up of executive and independent directors who account to the shareholders. Firms are required to set-up audit and remuneration committees, split the roles of Chairman and CEO, and to have at least two non-executive directors in their boards.

In a shift from the said King Report advocated for a stakeholder centred as well as an 'integrated' approach and introduced the principles of responsibility, fairness in addition to the focal principles of openness, integrity and accountability. It also advocated for stakeholder centred approach to governance thus requiring firms to consider a wider group on interest which include all stakeholders over and above conventional regulatory and financial aspects.

It sought to address good governance in publicly listed companies, the Johannesburg Stock Exchange appended the King Reports to its Listing Rules. While compliance with the Report was voluntarily, firms that opted not to comply with it were expected to provide an explanation for noncompliance.

The King Report is not free from weaknesses. As such, it has received a fair share of criticism despite having been at the fore front in creating awareness about good corporate governance and formally institutionalising corporate governance in SA.

The said report was criticised for abandoning the requirement that independent directors should not be involved in management which requirement would have otherwise enhanced the independence of corporate boards. It is further criticised for failing to contextualise issues touching

directly on the South Africans and thus failing to firmly relate its recommendations to issues such as equity in employment, economic empowerment of the black and HIV/AIDS.

Notably, the King Report led to the introduction of several affirmative actions and enactment of several pieces of legislation including, among others, Employment Equity Act 1998, the Labour Relations Act 1995 and the Black Economic Empowerment Act 2003 which sought to tackle the negative economic and social legacies of Apartheid.

Parallel to the legislative developments, South Africa has, since 1994, had a fair share of domestic corporate failures including, among others, Regal Treasury Bank, Leisurenent and Macmed. It was believed that the main reason behind these high profile corporate failures poor governance by those in management.

4.3.3 Recent Developments

South Africa is considering reforming its corporate governance laws with the aim of enhancing its application in the corporate sector¹³⁴ conforming to global trends on corporate governance while remaining contextually relevant and appreciating the peculiarities of the South Africa market.

South Africa has established a culture of reporting on the status of the South African corporate governance with the inaugural report in the series focusing on how the South African Code of Corporate Governance was established. The King Report provide guidelines for both State Owned Enterprises (SOEs) and private companies. As a result of these several self-regulatory initiatives, South Africa ranks among the top emerging economies with, and following corporate governance codes. Despite these major strides, questions abound on whether South Africa has sufficient institutional capacity to implement the codes.¹³⁵

4.3.4 King IV Report

This report came into effect on the 1 April 2017. It replaces previous reports and is universal, applying to both public and private entities. The King IV Report defines¹³⁶ corporate governance to mean the exercise, by the governing body, of ethical and effective leadership. The Report is

¹³⁴ Philip C. Aka “Corporate Governance in South Africa: Analyzing the Dynamics of Corporate Governance Reforms in the Rainbow Nation” Article 2

¹³⁵ Phillip Armstrong, Nick Segal and Ben Davis; “*Corporate Governance: South Africa, A Pioneer In Africa*”

¹³⁶ Institute of Directors of South Africa; *King IV Report on Corporate Governance for South Africa*, 2016 (King IV Report) pg. 11

focussed on achieving good outcomes on governance, namely: effective and good control, a culture that is ethical and legitimacy. Its objectives include, among others, promoting corporate governance and encouraging transparency to stakeholders.¹³⁷ Corporate Organisations in South Africa are encouraged to adopt the guidelines as stipulated in the report so as to meet the changing dynamics in the corporate sector.

The report contains seventeen (17) basic corporate governance principles out of which sixteen (16) are applicable to any organisation. They are based on the notion that good governance can always be practiced and learnt. The principles encourage firms to perceive corporate governance as an element that will yield results to an organisation if applied appropriately. To this end, stakeholders are required to make informed decisions on whether or not the organisation is performing well as regards the four good governance outcome set out by King IV Report.

The foreign relations of post-apartheid South Africa have been shaped largely by economic factors. In an attempt to overcome the extraordinary challenges, the South African government has always aggressively sought foreign aid, trade, and investment. The economic orientation of South African post-apartheid foreign policy is indicated by the prominent role the Department of Trade and Industry has played in the country's foreign affairs. It is with this vibrancy that has seen South Africa advance its mechanisms for corporate governance.¹³⁸

4.3.5 The Companies Act No. 71 of 2008

The above Act was assented to on 9 April 2009 and it was operationalized on 1 May 2011. It deals with companies' formation, administration and dissolution¹³⁹ and is not only aligned to international best practices but also harmonised with other South African statutes, including, among others, the Electronic Communications and Transactions (ECT) Act and the Promotion of Access to Information Act (PAIA).

The Act applies mainly to corporate governance, communications and public companies and has been simplified and made easier to understand and apply. It is beneficial for the following reasons:

- a) It is drafted in plain language and is not bulky compared to the previous Act.

¹³⁷ Ibid page 22

¹³⁸ Philip Aka (n133) above

¹³⁹ In Chapter two (2)

- b) Companies are allowed customise certain requirements and/or elements in line with their own circumstances.
- c) Rules are customised to fit the different types of companies, thus, while large public companies have arduous responsibilities on financial reporting and corporate governance, smaller companies have less arduous tasks.
- d) There is a general reduced regulatory burden on companies. However stricter transparency and accountability requirements apply for companies owned by the public and the state. Shareholders' right to access relevant company information is enhanced.
- e) The Act promotes greater participation of all stakeholder while enhancing accountability.
- f) The Act sets minimum accounting standards for annual reports and encourages high standards of corporate governance.

The Act provides for, and codifies, common law duties and liabilities of directors and sets stricter provisions to govern directors' conduct and liability. The Act saves a company's act from being rendered void, solely on the ground that the company lacked the capacity to act or that its directors lacked the authority to act on behalf of the company. This exception is however limited to certain specified circumstances. The Act further specifically prohibits a company from trade that is fraudulent, reckless or negligent and makes it an offence to knowingly participate in the above conduct.¹⁴⁰

In conclusion, it is evident that the United States and South Africa have succeeded in incorporating good corporate governance structures in financial institutions and that they have drawn lessons from the corporate scandals experienced in their jurisdictions. They have adopted global trends in corporate governance and codified them into laws. There is a lot that Kenya can learn from these two jurisdictions especially on how to bounce back from corporate scandals noting that Kenya has recently suffered the collapse of two banks. Most of the lessons learnt in this chapter shall be included as part of the recommendations in the next chapter.

¹⁴⁰ The Companies Act No.71 of 2008: "*An explanatory Guide*"; Department of Trade Industry; South Africa. Replacing the Companies Act No.61 of 1973

CHAPTER FIVE: CONCLUSIONS AND RECOMMENDATIONS

5.0 CONCLUSION

As the final chapter of this study, it summarizes the research findings and proceeds to discuss the implications of the findings for purposes of policy development in Kenya. It outlines recommendation for strengthening corporate governance to curb the menace of corporate corruption in the Kenyan banking sector. The findings of the research informs the conclusions drawn in this chapter. It proposes recommendations to be adopted by the relevant stakeholders and the parties concerned with the aim of curbing corruption witnessed within the Kenyan banks.

The study has diligently analysed the current corporate governance and corruption framework in Kenya and examined the efforts and level to which the corporate governance has been achieved and the extent to which it has been used successfully in fighting corruption. The study's objectives inform the author's detailed case study on two of the collapsed Kenyan banks – Dubai Bank and Imperial Bank.

A comparative review on the state of corporate governance and corruption in the US and South Africa was also conducted so as to enrich the study. It studied the corporate governance systems and structures in those jurisdictions. It examined a number of scandals in those jurisdictions and established their causes.

There are a number of lessons that can be learnt from these jurisdictions. South Africa and United States of America have adopted corporate governance practices that have strengthened their banking and financial systems.

The study concludes that good corporate governance and the principles thereof form a vital component for fighting corruption in the banking sector. The study has clearly shown that without applying good corporate governance mechanisms, corruption thrives and this may ultimately lead to the collapse of an institution.

The case study conducted has demonstrated that if the tenets for corporate governance are ignored, banks do collapse. It is vital that the management of banks demonstrate accountability, diligence, transparency and honesty in their management. It is clear that much work still needs to be done in

Kenya. It was also established that banks with weak corporate governance structures allowed for corrupt activities to thrive.

It is important that banks exercise good corporate governance due to their significant role in a country's economy. The significance of the banking sector in the economy of a country and the corporate scandals that have recently hit Kenya's the banking sector, informs the CBK's move to tighten the noose on fraudulent financial institutions. The CBK has enhanced the depth of reporting requirements through issuance of prudential guidelines and circulars to the banks.¹⁴¹

Banks play an important role in financial distribution. They also act as repositories for public savings and hence there is need to ensure that these savings are taken care of by law. The banking business has a lot of risks in it. Regulation, therefore, is important to the extent that it reduces risks and increases confidence on the part of the depositors and investors. There is, however, need to amend the relevant legislation and incorporate the corporate governance principles and mechanisms.

The importance of incorporating good corporate governance principles in all the enacted laws and adopted policy framework cannot be gainsaid. Equally, it is important to amend the existing legal, regulatory and policy framework to incorporate in them the software consisting of values, ethics, justice, principles and social infrastructure.¹⁴²

From the study conducted, the author is of the view that realisation of corporate governance has been achieved only to a minimal percentage. Much still needs to be done by the stakeholders, especially in the banking sector to fix the existing gaps in the corporate governance systems.

One of the challenges negatively impacting on corporate governance principle has been implementing laws which enshrine good corporate governance principles. Institutions that are tasked with regulating banks should play their regulatory role effectively. Specifically, CBK and CMA should monitor the banks' activities.

It is also important to appoint or elect only credible, honest, diligent persons as members of the banks' Boards of Directors.

¹⁴¹ Peter Rawlings (n1) above

¹⁴² Ibid.

Bank officials ought to be transparent and accountable to the bank's shareholders, depositors, stakeholders and other market participants. Do all banks, for example, honestly disclose critical information related to their risk profile such as levels of non-performing loans? In the case study conducted, there was non-disclosure on the part of the banks. Most of the two banks' activities were conducted in secrecy.

Institutional and, potentially, financial instability can result in liquidity shocks placing banks in precarious positions since they are uniquely vulnerable to liquidity shocks. To alleviate these risks, most developing countries are seeking to improve the efficiency and transparency of their state owned banks through wide ranging corporate governance reforms.

Development banks on the other hand are playing a more prominent role in emerging market sectors as they critically support financial inclusion, expansion of small and medium-size enterprises (SMEs), and housing, agriculture and infrastructure financing. These institutions are in the position to deliver effectively on their mandates where solid corporate governance measures exist.

5.1 Recommendations for reform

This study makes several key recommendations for reform founded on the findings of the research, case study and comparative analysis.

There is need for legislative reforms to be undertaken to adequately deal with issues of conflict of interest on the part of the directors. The Companies Amendment Act, 2017 provides for declaration of interest by the directors. It expands the scope of persons considered as the director's family. It is the director duty to declare to other directors any interest he has in any proposed or existing transaction with the company. The law should however clearly define what amounts to conflict of interest and how the interest should be declared. Whether the declaration and the decision by the other directors on the declared interest should be in registered in writing. Whether we can consider having in place an authority like in the USA to specifically deal with monitoring declarations and disclosures. The legal provisions like in the public sector should require the director not to take part in any decision making that he or she will benefit.

There is need for regulatory reforms to enhance capacity of regulatory authorities in implementing and enforcing the existing laws on corporate governance with specific interest on financial reporting. It is not enough to require banks to prepare and submit annual financial reports, more has to be done to ensure that the said reports are accurate and reliable. The current situation is more procedural than it is substantive. There is need to reform the financial reporting standards to enable the regulator detect cooked reports and to take immediate action before the situation gets out of hand. The USA has an oversight authority that monitors financial reporting by setting standards and requirements for reporting with an aim of protecting the stakeholders. Kenya can benefit from such an authority as it will provide the required scrutiny of the reports to ensure what is reported is the true reflection of the financial status of the banks. In South Africa, the Kings Report II provides guidelines on reporting which requires the reports to contain correct information. The reforms should take into consideration, the timelines for submission of report, the review and feedback, and in-case weaknesses are detected remedial action is taken.

The Kenya Bankers Association should develop effective self-regulation mechanisms and guidelines to ensure banks embrace corporate governance best practices. The said self-regulation guidelines should be codified and attract sanctions. The Association also needs to develop standards of recruitment training and continuous vetting of senior managers of banks.

The study conducted demonstrates that good corporate governance is integral to an organisation's success since it allows for the directors to be accountable to the shareholders while helping organisations avoid ethical, legal and financial pitfalls.

Good corporate governance serves as an integral framework for securing investor confidence, promoting growth and strengthening economies and enhancing access to capital markets as it provides checks and balances to officials in positions of power. It has the effect of increasing a company's output. Corporate governance is important, useful and beneficial in all types of organisations whether small business, state-owned enterprises, multinationals, domestic firms or family-owned operations.¹⁴³

This research was only limited to corporate governance and corruption in the banks. There is need to extend the research to cover Savings and Credit Cooperatives Societies (SACCOS), insurance

¹⁴³ Irum Shahid, '*Strengthening Corporate Governance to Combat Corruption*' Transparency International 2009

firms and small and medium micro finance institutions as well. Due to the role corporate governance plays in ensuring financial stability, sustainable growth and economic efficiency there is need to review corporate governance in the above cited financial institutions.

Companies in Kenya have increasingly and progressively pursued mechanisms to improve their performance by adopting good corporate governance practices. The study's findings demonstrate that application of good corporate governance in banks can improve their efficiency and thus their profitability. Kenya still has a long way to go. However, it is important to note that relatively and in comparison to the African countries, Kenya has made great strides in embracing good corporate governance practices. Steadily, Kenya shall overcome the scourge that is corruption in banks and other financial institutions.

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