

**THE RELATIONSHIP BETWEEN BOARD STRUCTURE AND
FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN
KENYA**

**BY
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DECLARATION

This research is my own original work and has not been presented for a degree in any other university.

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This research project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

To members of my family for their encouragement and moral support during the period of this study.

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TABLE OF CONTENTS

DECLARATION	ii
DEDICATION	iii
ACKNOWLEDGEMENT	iv
LIST OF TABLES	vii
LIST OF FIGURES	viii
ABBREVIATIONS	ix
ABSTRACT.....	x
CHAPTER ONE: INTRODUCTION	1
1.1 Background to the Study.....	1
1.1.1 Board Structure	2
1.1.2 Financial Performance.....	4
1.1.3. Board Structure and Financial Performance	5
1.1.4 Banking Sector in Kenya.....	5
1.2 Research Problem	6
1.3 Research Objective	8
1.4 Value of the Study	8
CHAPTER TWO: LITERATURE REVIEW	9
2.1 Introduction.....	9
2.2 Theoretical Framework.....	9
2.2.1 Shareholders Theory	9
2.2.2 Stakeholder Theory	10
2.2.3 Agency Theory.....	11
2.2.4 Stewardship Theory.....	12
2.3 Determinants of Financial Performance of Commercial Banks	12
2.3.1 Internal Determinants of Bank Performance.....	12
2.3.2 Macroeconomic and Industrial Determinants of Bank Performance	14
2.4 Empirical Evidence.....	15
2.5 Summary of Literature Review.....	17
CHAPTER THREE: RESEARCH METHODOLOGY	19
3.1 Introduction.....	19

3.2 Research Design.....	19
3.3 Population	19
3.4 Data Collection Procedure	19
3.5 Data Analysis Techniques.....	20
3.5.1 Conceptual Model.....	20
3.5.2 Analytical Model	21
CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION.....	24
4.1 Introduction.....	24
4.2 Descriptive Statistics.....	24
4.2.1 Financial Performance of Commercial Banks	25
4.2.2 Board Structure of Commercial Banks	25
4.2.3 Other Determinants of Financial Performance of Commercial Banks	28
4.3 Correlation Analysis	29
4.4 Regression Analysis.....	33
4.4.1 Analysis of Variance	34
4.4.2 Regression Coefficients.....	35
4.5 Chapter Summary	37
CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS.....	38
5.1 Introduction.....	38
5.2 Summary of Findings.....	38
5.3 Conclusion and Recommendations.....	40
5.4 Limitations of study	44
5.5 Suggestions for further studies.....	44
REFERENCES.....	46
APPENDICES	53
Appendix I: Introduction Letter	53
Appendix III: List of Commercial Banks in Kenya.....	54

LIST OF TABLES

Table 4.1: Commercial Bank Profitability	25
Table 4.2: Board Size	25
Table 4.3: Age of Commercial Banks in Kenya	28
Table 4.4: Ownership Structure of Commercial Banks	29
Table 4.5: Peer Groups of Commercial Banks in Kenya	29
Table 4.6: Correlation Matrix.....	32
Table 4.7: Regression Model Summary	34
Table 4.8: ANOVA Analysis	35
Table 4.9: Regression Coefficients	36

LIST OF FIGURES

Figure 4.1: Board Committees	26
Figure 4.2: Proportion of Female Directors in Boards of Commercial Banks.....	27
Figure 4.3: Proportion of Foreign Directors in Boards of Commercial Banks.....	28

ABBREVIATIONS

BAC	:	Board Audit Committee
CBK	:	Central Bank of Kenya
CEO	:	Chief Executive Officer
CRB	:	Credit Reference Bureau
GDP	:	Gross Domestic Product
MFB	:	Microfinance Bank
MFC	:	Mortgage Finance Company
NED	:	Non Executive Director
NSE	:	Nairobi Securities Exchange
OECD	:	Organisation for Economic Co-operation and Development
ROA	:	Return on Assets
ROE	:	Return on Equity

ABSTRACT

There is no specific optimal board structure that applies to all banks; every board considers whether its size, diversity and demographics make it effective. The objective of the study was to investigate the relationship between board structure and financial performance of commercial banks in Kenya. Data was collected from the 42 commercial banks which were operational in Kenya for three years - 2011, 2012 and 2013. ROA was used in this study to measure financial performance. Data was collected in relation to various elements of board structure, specifically: board size, director independence, board meetings, compensation committee, nomination committee, audit committee, gender diversity and foreign directors. Control variables used in this study were: bank age, ownership structure and peer group. Data was analyzed using descriptive and inferential statistics.

Correlation analysis shows strong positive relationship between ROA and age of a bank and bank size – CBK has classified banks as either small or medium or large size. The study found existence of weak positive relationship between ROA and size of the board, existence of a nomination committee and the proportion of female directors. The study found negligible relationship between ROA and the number of board meetings, existence of a compensation committee, the size of the audit committee, the proportion of foreign directors and bank ownership structure. The analyses showed that board structure elements account for 45% of the financial performance of commercial banks. Of all the variables under study, compensation committee, nomination committee, audit committee size, proportion of foreign directors and bank's peer group were found to be significant predictors of bank financial performance. The other variables – board size, director independence, board meetings, audit committee independence, audit committee meetings, gender diversity, bank age and ownership structure – were found to be insignificant predictors of ROA.

This study makes the following recommendations: policy makers should consider making it mandatory for banks to establish nomination committees; policy makers should set up higher capital requirements for banks; boards should consider establishing ad hoc, rather than permanent, compensation committees; boards should ensure they have lean sizes of audit committees; and foreign owned banks should consider recruiting more local than foreign directors.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

The need for effective corporate governance has gained prominence since the collapse of a large number of renowned companies. In responding to corporate failures, many governments have made incremental changes to their financial markets' corporate governance requirements. Although there are a large number of studies on different aspects of corporate governance in developed markets (Jensen and Meckling, 1976; Mourdoukoutas & Papadimitriou, 1998; Jackson & Moerke, 2005), little is known about corporate governance pillars and its role in the banking sector of emerging and developing economies.

The primary objective of corporate governance is to minimize the principal-agent problems between managers and shareholders and between directors and shareholders. Monitoring these principal agent challenges result in agency costs to shareholders. To reduce these costs, shareholders nominate corporate directors to monitor and prevent principal-agent problems that may arise in the firm (Shleifer & Vishny, 1997). The board of directors is at the core of ensuring that good corporate governance is practiced by a firm (Desender, 2009; Lefort & Urzaa, 2008).

Bank corporate governance in developing countries, such as Kenya, is important for several reasons. First, banking institutions play a critical role in developing-economy's financial systems, and are extremely important engines of economic growth (King & Levine, 1993a, b; Levine, 1997). Second, because of the underdeveloped nature of these economies, banks are the most important source of finance for the majority of firms (Arun & Turner, 2002). Finally, banks in developing countries play a major role in the payment system and are the main depository for savings (Nyamongo & Kebede, 2013).

Both academics and practitioners alike recognize the critical importance of mechanisms of corporate governance. The debate lately has focused on the structure and functioning of board of directors and its relationship with firms' financial performance (Jensen, 1993).

1.1.1 Board Structure

Board structure refers to the dimensions of the board's organization, covering the number and types of committees, committee membership, and the flow of information among these committees and board leadership (Zahra & Pearce, 1989). The primary duties of the board include: monitoring and controlling managers, providing information and counsel to managers, monitoring compliance with applicable laws and regulations, and linking the firm to the external environment (Monks & Minow, 2004).

Hermalin and Weisbach (1998) suggest that the one important criterion to ensure the success of the board of directors in performing their duties is to have an effective board structure in place. Brennan (2006) found the monitoring duties of a board are influenced by factors such as board composition, board culture, board diversity, board size, CEO duality and information asymmetries. The extent to which the board would be effective in carrying out its roles depends on exogenous factors, which among others may be made up of specific board characteristics like board size, director independence, board diversity, board meetings and committee structures.

Board size is the total number of head counts of directors seated on a company's board. Jensen (1993) argues that large corporate boards are less effective due to the problems of coordination, control, and flexibility in decision-making and give excessive control to CEOs. Yermack (1996) and Eisenberg et al. (1998) provide support by showing that firms with small boards had superior financial performance. However, other researchers argue that larger boards may improve firm performances by facilitating manager supervision and bringing more human capital to advice managers. Dalton et al. (1999) find that large boards positively impact firm performance, particularly for firms requiring more advising such as complex firms that operate in multiple segments.

Director independence is a measure of the proportion of independent non-executive directors to the total number of directors in a company. Corporate governance literature offers no conclusive evidence on the role of independent directors. Hermalin and Weisbach (1998) find no statistically significant impact of a firm's number and/or percentage of outside directors on firm performance. Agrawal and Knoeber (1996) shows that the presence of independent directors decreases firm value.

Foreign directors refer to those directors who are nationals of the country in which the entity is registered. Foreign directors might bring new technology and modern managerial techniques, enhance corporate governance, exert better supervision and subsequently improve bank performance. Oxelheim and Randoy (2003) find a significantly higher value for firms that have foreign Anglo-American board members using a sample of firms with headquarters in Norway or Sweden. Berger et al. (2006) point out that one mechanism through which minority foreign ownership might increase banks' efficiency is to take positions on the board and "leverage" the positions to monitor and improve bank management. Therefore, the presence of foreign directors on the board might improve banks' performance and asset quality. Black et al. (2006) provide evidence that for Korean firms, the presence of foreign director does not predict higher market value.

Gender diversity refers to the proportion of female directors in the board. Gender diversity has recently become a theme in governance reform worldwide. The business case for gender diversity is that board diversity enhances the effectiveness of board actions which increases the productivity and performance of a bank (Robinson & Dechant, 1997). However, evidence on how gender diversity impacts firm performance is mixed.

Frequent board meetings may be a signal of a proactive board. The more frequent the meetings, the increased supervision of the top management, the more relevant the advisory role, which might improve firm performance. Furthermore, the complexity of the banking business requires a more active role of the board.

Alternatively, the frequency of board meetings may increase in times of financial distress or in times of controversial decisions. Vafeas et al. (1999) show that frequency of board meetings is negatively related to performance, which may be the result of boards meeting more often to address poor performance.

The primary delegated roles of board committees are to monitor and review financial statements, determine remuneration, and nominate new directors. The BAC is the most studied and perhaps the most important of all the board committees. CBK Prudential Guidelines have made it compulsory for all banks to constitute a BAC consisting of a minimum of three members, all non-executive and meet at least once per quarter. BAC works as another internal control mechanism in the board structure, 'the impact of which should be to improve the quality of the financial management of the company and hence its performance' (Weir et al, 2002).

1.1.2 Financial Performance

Financial performance is a measure of the accountability of an entity for the results of its policies and operations quantified in financial terms for an identified period. Financial performance is important to the different groups of people that have to make financial decisions about a company's financial position. Business owners, managers, potential investors, banks, other financial institutions, creditors, business partners, employees, and government are interested in models that help to analyze and predict the performance of the companies (Karpoff et al, 1994). Financial performance of banks and other financial institutions has generally been measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies (Avkiran, 1995).

The operating performance of a bank can be measured by ROA ratio which shows the amount of earnings that have been generated from invested capital assets (Epps & Cereola, 2008). Managers are directly responsible for the operations of the business and therefore the utilization of the firms' assets.

ROA allows users to assess how well a banks' corporate governance mechanism is in securing and motivating efficient management of the bank. In this study, ROA is defined as net income before tax for the fiscal period divided by total assets for that same period.

1.1.3. Board Structure and Financial Performance

The issue of board structure and financial performance has received considerable attention in international research in recent years (Jackling & Johl, 2009). However, these studies have yielded contradicting results. Some studies find that large boards are less effective and are easier for the CEO to control (Lipton & Lorsch, 1992). Yermack (1996) found a negative correlation between large board size and profitability. Eisenberg et al. (1998) and Mak and Kusnadi (2005) noted that small boards are positively related to high firm performance.

Hermalin and Weisbach (1991) and Bhagat and Black (2002) found no significant relationship between board composition and performance. Yemack (1996) also showed that, the percentage of outside directors does not significantly affect firm performance.

1.1.4 Banking Sector in Kenya

As at 31 December 2013, the banking sector comprised of the Central Bank of Kenya, 44 banking institutions (43 commercial banks and 1 MFC), 7 representative offices of foreign banks, 9 MFBs, 2 CRBs and 101 forex bureaus. Out of the 44 banking institutions, 30 were locally owned banks – comprising of 3 with public shareholding and 27 privately owned - while 14 were foreign owned. The 9 MFBs, 2 CRBs and 101 forex bureaus were privately owned. The foreign owned financial institutions comprised of 10 locally incorporated foreign banks and 4 branches of foreign incorporated banks (Central Bank of Kenya, 2014).

CBK is responsible for regulation and supervision of banks. Over the past decades, there have been numerous revisions to the Banking Act, Central Bank of Kenya Act and prudential guidelines aimed at strengthening CBK's supervisory role.

The Banking Act has been reviewed over time to give more legal powers to the regulatory authority and to broaden the responsibilities and coverage of institutions. Some of the key enhancements in corporate governance requirements include: introduction of ethical leadership as envisaged in the new constitution factoring issues of ethics, transparency and diversity; strengthening board independence through requiring at least one third of directors to be independent; and clear demarcation of roles of board and management through board charters (CBK Prudential Guidelines, 2012).

The total net assets in the banking sector stood at Ksh. 2.7 trillion as at 31 December 2013. During the same period, there were 6 large banks with a market share of 52.39%, 15 medium banks with a market share of 37.95% and 22 small banks. Total income rose from Ksh. 356.3 billion in December 2012 to Ksh. 362.2 billion in December 2013 while staff levels rose from 31,636 in 2012 to 34,059 in 2013. The increase in income was largely attributed to increase in fees and commissions and interest on government securities (Central Bank of Kenya, 2014).

1.2 Research Problem

It is widely accepted that effective corporate governance is of essence to a bank's financial performance because well governed banks largely perform better financially. Effective corporate governance benefits banks through greater access to financing, lower cost of capital, better financial performance and more favourable treatment of all stakeholders. Conversely, weak corporate governance leads to poor firm financial performance and risky financing patterns.

Boards are the most important component of corporate governance mechanisms. In order for a board to fulfil its responsibilities, it has to be constituted and structured in a way that will enable it to effectively and efficiently perform its duties. Board structure is operationalized around a number of elements such as board size, director diversity, committees and frequency of meetings. Agency and shareholder theories prescribe that boards should be comprised of outside directors who are thought to provide superior performance benefits to the firm as a result of their independence from management.

Stewardship theory on the other hand suggests that control should be firmly centralized in management's hands. Stakeholder theory roots for diversified and a large number of directors in the board.

In light of the significant changes in the banking operating environment, CBK revised the banking sector regulatory framework in a bid to improve the way banks are directed and controlled. CBK Prudential Guidelines (2012) do not prescribe an optimal board structure but require every board to consider whether its size, diversity and demographics make it effective. CBK requires all licensed banks to adopt practices like having at least five directors of which three-fifths should be independent directors; having board committees; directors not having multiple directorships in more than two licensed institutions among other requirements. It is not clear which of board elements, if any, are significant to financial performance of commercial banks in Kenya. It is also unknown whether the revised corporate governance guidelines in the regulatory framework would result in improved bank performance.

While a number of studies have been conducted on the effect of board structure on bank financial performance in developed countries, similar studies are scanty in the developing countries. Only a few studies can be found on relationship between board structure and financial performance of commercial banks in Kenya with exception of Mandu (2012), Mbugua (2012), Gacheru (2013), Chepkosgei (2013), Nyamongo and Kebede (2013). Like similar studies elsewhere, studies conducted in Kenya have produced differing results. These prior studies have not been exhaustive in covering a number of board elements and control variables, and examples abound. The financial impact of diversity, a concept greatly been promoted in Kenya's 2010 Constitution, has not been researched in the context of commercial banks. Similarly, studies on board committees and foreign directors and their effect specifically on bank performance are yet to be conducted in Kenya. Crucially important is the fact that past studies on this topic covered periods prior to 2013, the year when the revised prudential guidelines came into force.

To bridge this research gap and to contribute to the debate on board structure, this study used an extensive set of board characteristics (size, composition, board committees, diversity and functioning of the board) to analyze the impacts of board characteristics on bank financial performance. The study was aimed at providing useful information about banks' board structure in the context of the CBK Prudential Guidelines (2012) specifically on corporate governance, and more importantly investigated the effectiveness of boards of the Kenya banking sector.

1.3 Research Objective

The objective of the study is to investigate the relationship between board structure and financial performance of commercial banks in Kenya.

1.4 Value of the Study

This study will be valuable in a number of ways. First, the study sought to extend the literature on corporate governance in general and commercial banks in particular in Kenya. The study was aimed at providing information to potential and current scholars and practitioners in regard to the relationship between board characteristics and financial performance of commercial banks.

Second, the study attempted to provide a more complete picture of the board structure and its role in the Kenyan banking sector by examining a comprehensive set of board characteristics to capture different aspects of board and their impacts on bank performance. The study measured the strength of the relationship among the different board elements.

Third and finally, the study sought to provide more knowledge to policy makers on the banking sector's board dynamics in order to design appropriate responses to the needs of commercial banks in Kenya. These responses, the study hoped, would result in improvements in financial performance of the banking sector.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter will review literature from other researchers who have carried similar studies in the past. The specific areas covered in this chapter are: theoretical framework, determinants of financial performance of commercial banks – discussing factors, other than board structure, that influence financial performance of banks -, empirical literature (section 2.4) and a summary of literature review.

2.2 Theoretical Framework

This study considered the following theoretical frameworks in explaining and analyzing corporate governance: shareholders theory, stakeholders theory, agency theory and stewardship theory.

2.2.1 Shareholders Theory

There are two main theories of shareholder-oriented governance: the principal-agent or finance model and the myopic market model. According to the principal-agent model, the central problem of corporate governance is self-interested managerial behavior in a principal-agent relationship. The separation of ownership and control increases the power of professional managers and gives them freedom to pursue their own aims and serve their own interests at the expense of shareholders (Berle & Means, 1932). There are two problems occurring in the agency relationship with which agency theory is concerned. The first is that because it is difficult or expensive for the principal to verify what the agent is actually doing, the principal cannot verify that the agent has behaved appropriately. The second problem is that the principal and the agent may prefer different actions because of the different attitudes toward risk (Eisenhardt, 1989).

Principals attempt to ensure that agents act in principals' interests and this result in “agency cost” (Jensen & Mechling, 1976). To solve those problems, agency theory must determine the most efficient contract governing the principal-agent relationship and an

optimal incentive scheme to align the behavior of the managers with the interest of owners. The board of directors is one such mechanism of reducing the principal-agent problem. The myopic market model holds that what is wrong with corporate governance is that the system encourages managers to focus on short-term performance by sacrificing long-term value and competitiveness of the corporation. The financial markets often force managers to behave in a way divergent from the maximization of long-term wealth for shareholders (Blair, 1995).

Shareholders theorists argue that an ideal board should consist of individuals with varieties of external linkages that bring within the firm's reach access to essential resources (Hillman, Keim & Luce, 2001) and that appropriate representation by independent non-executive directors is likely to lead to improved firm performance (Hillman et al., 2001; Muth & Donaldson, 1998; Nicholson and Kiel, 2007).

2.2.2 Stakeholder Theory

Abuse of executive power is particularly embedded in the problem of executive overpay since executive remuneration has risen far faster than average earnings and there is at best a very weak link between compensation and management performance (Conyon et al., 1995; Gregg et al., 1993). The only restraint on executive pay seems to be the modesty of executives themselves, and the creation of so-called independent remuneration committees by large companies is not effective. The supporters of this model do not believe that the main lines of corporate governance reform, such as non-executive directors, shareholder involvement in major decisions and fuller information about corporate affairs, are suitable monitoring mechanisms (Kay & Silberston, 1995). Instead, they propose statutory changes in corporate governance, under which hostile takeovers are not possible to effect, since ownership of shares no longer brings the right to appoint executive management.

Stakeholder theorists advocate for a large and well diversified board of directors which can accommodate the interest of each stakeholder, especially those that create value to the firm, in order to realize success in driving firm performance (Ayuso & Argandoña,

2007; Clarkson, 1995; John & Senbet, 1998). A key gap in this theory is that if boards are to consider other interests, director activity would become less focused, which might lead to poor financial performance.

2.2.3 Agency Theory

Employees or managers may not necessarily make decisions in the best interests of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976). The Agency theory is concerned with resolving two problems that can occur in agency relationships. The first problem that arises when (a) the desires or goals of the principal and agent are different and (b) it is difficult or expensive for the principal to verify what the agent is actually doing. The second problem is the risk sharing that arises when the principal and agent have different attitudes towards risk. The principal-agent problem treats the difficulties that arise under conditions of incomplete and asymmetric information when a principal hires an agent. Various mechanisms may be used to try to align the interests of the agent with those of the principal, such as piece rates/commissions, profit sharing, efficiency wages, the agent posting a bond, or fear of firing. The board of directors is tasked to make such determinations and put in place mechanisms to align principal-agent interests. This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.

Agency theory suggests that a large board of directors becomes a symbolic mechanism and part of the management itself. Since a large board of directors cannot be effective, so it cannot carry out its monitoring role and as a consequence it might negatively affect performance. Agency theorists argue that a higher proportion of independent nonexecutive directors on the board will make different and perhaps better decisions than a board dominated by executive directors, potentially having a positive impact on firm performance (Fama & Jensen, 1983). A gap in the agency theory is the inward focus of directors and managers who forget that a firm exists to serve interests of all stakeholders.

2.2.4 Stewardship Theory

Stewardship theory suggests that stewards are satisfied and motivated when organizational success is attained (Donaldson & Davis, 1991). Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work at them diligently. Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. Proponents of stewardship theory suggest that this would result in better safeguarding of the interest of the shareholders.

Stewardship theorists argue that smaller board sizes promotes increased participation and social cohesion whereas larger board sizes inhibits the board's ability to reach consensus on important decisions (Muth & Donaldson, 1998; Yermack, 1996). Stewardship theorists also argue that executive-dominated boards should be favoured for their depth of knowledge, access to current operating information, technical expertise and commitment to the firm, potentially having a positive impact on firm performance (Letting' et al., 2012; Muth & Donaldson, 1998). Some empirical evidence however suggests that financial performance is greatly improved by combining these two roles (Donaldson & Davis, 1991).

2.3 Determinants of Financial Performance of Commercial Banks

Board structure alone does not determine financial performance of commercial banks. Other factors, both internal and external to a bank, tend to play an even greater role than the structure of boards. These factors can be categorized into two: bank internal factors and macroeconomic and industrial factors.

2.3.1 Internal Determinants of Bank Performance

At the very least, five internal factors are important for explaining banks performance: bank size, capital ratio, liquidity level, credit risk, operational costs, deposit demand, diversification of services and ownership structure.

Bank size has been generally used as an indicator of economies of scale (Berger & Humphrey, 1997). However, the evidence is not conclusive. Goddard et al. (2004) suggest that economies of scale disappear when important size increases occur, which can negatively affect bank performance. Inversely, banks with greater size are able to raise capital at a lower cost, and thus they appear to be more profitable (Short, 1979; Bikker & Hu, 2002; Goddard et al., 2004).

Empirical evidence suggests a positive relation between performance and solvency. Lin et al. (2012) suggest that capital ratio has a positive relation with interest margin due to increases in financing costs related to equity capital. Lack of liquidity and asset-liability mismatch are the common causes of failure both in banks and economies. Bourke (1989) finds a positive relation between liquidity and performance, which contradicts the classic argument that higher liquidity levels imply higher costs.

The banking industry is inherently exposed to higher levels of credit risk than nonfinancial institutions. Consequently, it potentially has more non-performing loans, and thus lower rates of return and performance may be expected (Athanasoglou et al., 2008). Operational expense is important as it is often considered an indicator of administrative efficiency. Empirical evidence shows that higher administrative efficiency has a positive effect on performance. Demand for deposits is usually considered as an indication of growth opportunities. Evidence suggests that higher growth opportunities also have a positive effect on performance (Berger, 1995b, 1995a; Goddard et al., 2004; Berger et al., 2006).

Empirical evidence is not conclusive with respect to the effect of diversification on bank performance. Lin et al. (2012) show that when banks implement diversification strategies, they put their emphasis on new business lines, thereby decreasing their idiosyncratic risk. Brunnermeier et al. (2012) suggest that income from nontraditional activities significantly reduces banks' systemic risk. However, DeYoung and Roland (2001) find that U.S. banks that adopt diversification strategies exhibit increases in income volatility, operational and financial leverage, and performance.

The ownership of commercial banks influences the performance of commercial banks. Government owned banks tend to have poor performance due to complications associated with political interference in board and employees recruitment and selection processes. However, privately owned commercial banks that are locally owned tend to have problems associated with size. However, foreign-owned banks tend to perform better because most of them are subsidiaries of large banks (Nyamongo & Kebede, 2013).

2.3.2 Macroeconomic and Industrial Determinants of Bank Performance

Studies at macroeconomic level have primarily focused on two factors: inflation and economic growth. Revell (1979) suggests that inflation may significantly affect bank performance by increasing industry operational expenses.

A number of studies have shown how bank performance is positively influenced by economic growth. De la Torre et al. (2011) indicate that GDP growth is important in the promotion of bank credit, thereby reducing bank liquidity.

Researchers at the industry level have generally focused on the industry concentration level and the main property structures. Bank concentration level can be addressed with the market power hypothesis or the efficient structure hypothesis both of which propose a positive relation between the concentration level of the industry and bank performance (Athanasoglou et al., 2008). The market power hypothesis suggests that a greater concentration level within the industry implies higher monopolistic returns for its participants (Bourke, 1989; Molyneux & Thornton, 1992). The efficient structure hypothesis suggests that those banks with superior production or administration technologies have lower costs, reach a higher concentration level, and, consequently, have higher returns. More concentrated industries do not necessarily develop more efficient structures, but a higher degree of competition may lead to greater efficiency. Nevertheless, the expectation is for a positive relation between bank industry concentration and financial performance.

2.4 Empirical Evidence

Shrader, Blackburn and Iles (1997) investigated the relationship between the percentage of female board members and financial performance (using ROA and ROE) for a sample of approximately 200 Fortune 500 firms. They find a significant negative relationship between the percentage of women on the board and firm value in some tests. Carter et al. (2003) report a positive relationship between board diversity (measured by the presence of women and minorities) and firm value. Using a sample of 638 Fortune 1000 firms, the results of this study suggest that a higher percentage of women and minorities on the board of directors can increase firm value. The study also suggests that the proportion of women on boards is a significant determinant of the fraction of minority directors on boards.

Using secondary data of quoted companies in the NSE, Mululu (2005) suggests that board activity, as measured by the frequency of board meetings, is positively related to the financial performance of firms. The results suggest that board meetings are an important dimension in board operations and particularly in the board's ability to effectively monitor management and improve firm's performance. Aosa, Machuki, and Letting (2012) examined the relationship between board diversity and financial performance of 40 firms listed in the NSE. The results indicate a statistically not significant effect of board diversity on financial performance.

Mandu (2012) examined the relationship between measures of board independence and the financial performance of commercial banks in Kenya. Data for the period 2004 through 2008 for 36 banks were obtained from the annual financial reports of commercial banks in Kenya. The study concluded that board composition has a significant negative correlation with performance of smaller firms and not for larger firms. Mbugua (2012) examined the relationship between board diversity and financial performance of commercial banks registered and domiciled in Kenya. Data on Boards' gender, educational qualifications, study specialization, and board specialization as well as the companies' financial performance were obtained from CBK's supervisory department

where a total of 33 banks reports were sampled. The results show that there is very minimal association between board diversity and financial performance.

A number of empirical studies on the effect of board size have been conducted in Kenya and globally with mixed results. Chepkosgei (2013) studied the influence of board composition on financial performance of 43 commercial banks in Kenya. Findings of the study revealed that board size, average tenure, ratio of female directors, occupational experience of the directors and ratio of non-executive could significantly predict only ROE and ROA. Corporate governance literature offers no conclusive evidence on the role of independent directors. In the Kenyan context, Nyamongo and Kebede (2013) investigated the effect of corporate governance on the performance (measured by ROA & ROE) of 37 commercial banks in Kenya over the period 2005-2009. The study follows a panel econometrics technique to investigate the relationship between governance variables and bank performance. The main findings were that the existence of independent board directors tends to enhance the performance of the banks and that a large board size tends to impact performance negatively.

Gacheru (2013) comprehensively studied the relationship between BAC effectiveness variables and financial performance of commercial banks in Kenya over the period 2007 to 2011. The study examined specific structural and operational characteristics of BACs for the banks. Data for five year financial periods between 2007 and 2011 was obtained for 25 banks. The main findings are as follows: there is a significant positive correlation between percentage of BAC members with financial expertise and ROE; the percentage of independent non-executive directors in BAC has a significant positive correlation with ROE; changes in BAC membership do not affect ROE; the attendance rate for BAC meetings has a significant positive correlation with ROE; there exists a significant positive correlation between size of BAC and ROE; and the number of BAC meetings in a financial year has a significant effect on ROE.

Opanga (2013) sought to establish how the number of directors, number of resolutions passed in general meetings, number of committees and the frequency of holding meetings

affect the insurance firms' financial performance in Kenya. An 80% sample of the 45 insurance firms in Kenya during the period of 2010 – 2012 was used in the study. The study established that the number of board committees, board meeting frequency, number of resolutions passed in an AGM and number of board of directors all are positively correlated with financial performance.

2.5 Summary of Literature Review

This chapter reviewed literature relating to board structure and its impact on financial performance from different theoretical perspectives. Stakeholder theory is premised on the impression that the firm is a social entity that is responsible and accountable to a broader set of actors beyond its owners. Agency theory is built on the notion that separation of ownership and control potentially leads to self-interested actions by managers. Agency theorists root for small board sizes. According to agency theory, the main contribution of independent directors is their ability to remain independent while overseeing operating matters. Stewardship theory suggests that the main role of the board of directors is to advise and support management rather than to discipline and monitor as agency theory prescribes. Stewardship theory also suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization.

Empirical studies on the effects of board structure on financial performance have elicited mixed results. Several researchers suggest that the number of directors can influence the functioning of the board and therefore the performance of the company. However, another stream of literature shows that large boards are less effective and have a negative impact on performance. One strand of the literature argues that the presence of independent directors on the board tends to lessen the conflict of interests and be more effective in reducing the agency problem. Evidence on the impact of board diversity (gender, racial and ethnic composition of the board) has also turned out mixed results. Generally, the more frequent the board meetings, the increased supervision of the top management, the more relevant the advisory role, which might improve firm performance.

Jackling and Johl (2009) suggest that the differences in empirical findings have in part been attributed to the differences in the theoretical bases of investigation. Othman, Ponirin and Ghani (2009) attribute the differences to the sample used. Some studies focus on examining only large listed companies and other studies exclusively focus on particular economic sectors. Another reason for the difference in empirical findings linking board structure to firm performance is the different setting of each country these studies are conducted (Othman et al, 2009).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

In this chapter the research methodology to be used in the study is described. The study design and the population are detailed. The instruments to be used to collect the data, methods that will be used in data analysis are also explained. The specific areas covered under in this section are: Research Design, Population, Data Collection Procedure, and Data Analysis Techniques.

3.2 Research Design

The research problem was studied through the use of a descriptive research design and analysis. According to Cooper and Schindler (2003) a descriptive study is concerned with finding out the what, where and how of a phenomenon. This study was undertaken using a causal research design: the research design attempted to explore cause and effect relationships between two or more variables (Ader, Mellenbergh & Hand, 2008).

3.3 Population

The target population for a survey is the entire set of units for which the survey data are to be used to make inferences. The population used in this study was all commercial banks regulated by CBK. The study was a census survey covering all the 43 commercial banks in existence in Kenya. The banks were classified into: local public commercial banks, local private commercial banks and foreign commercial banks.

3.4 Data Collection Procedure

This study targeted all of the 43 commercial banks in existence in Kenya from 1 January 2011 to 31 December 2013. Secondary data was collected from the audited financial statements of commercial banks in Kenya available at the Bank Supervision and Deposit Protection Fund Annual Reports of CBK.

3.5 Data Analysis Techniques

Collected data was validated, coded and checked for any errors and omissions. For the purpose of empirical analysis, this study used descriptive statistics, Pearson correlation analysis and linear multiple regression as the underlying statistical tests. Regression analysis was performed to test the relationship between the dependent variable and independent variables (board structure characteristics).

3.5.1 Conceptual Model

This study sought to establish how the various board structure variables affect financial performance of banks. The study conceptually utilized the model shown below:

$$Y_i = f(X_1, X_2, X_3, X_4, X_5, X_6, X_7, X_8, X_9, X_{10}, X_{11}, X_{12}, X_{13}, X_{14})$$

Where

- Y_i : The Dependent Variables (ROA)
- X_1 : Board size - the number of directors in a board
- X_2 : Director independence - whether executive or non-executive director
- X_3 : Number of board meetings held in a year
- X_4 : Compensation committee – existence of compensation committee of the board
- X_5 : Nominations committee – existence of nomination committee of the board
- X_6 : Audit committee – existence of audit committee of the board
- X_7 : Number of audit committee members
- X_8 : Number of audit committee non - executive members
- X_9 : Number of audit committee meetings in a year
- X_{10} : Board diversity by gender - the proportion female directors in the board
- X_{11} : Foreign directors – proportion of non-Kenyan directors in the board
- X_{12} : Age of bank – a control variable measuring the number of years the bank has been operating
- X_{13} : Ownership – a control variable on whether the bank is publicly, privately or foreign owned
- X_{14} : Peer group – a control variable on whether the bank is small, medium or large in size

3.5.2 Analytical Model

Past studies have shown that for directors to effectively execute their mandate, the board has to have the right structure (Hermalin & Weisbach, 1998). In Kenya, various structural elements of boards have individually been studied across a number of industries, mainly for companies listed at the NSE. Nyamongo and Kebede (2013) built their model around board size and independent directors to study the relationship between board structure and financial performance. Mululu (2005) utilized the frequency of board meetings while Aosa, Machuki, and Letting (2012) used board diversity in their models. Gacheru (2013) developed a model consisting of the percentage of independent NEDs in BAC, the size of BAC and the number of BAC meetings to study BAC structure and its relationship to financial performance. Opanga (2013) used the number of committees and the frequency of holding meetings as variables in the model to study board structure and financial performance.

In this study, the regression model utilized to test the relationship between the board characteristics and financial performance is expressed as:

$$Y_{i,t} = \beta_0 + \beta_1 BODNO_{i,t} + \beta_2 BODNED_{i,t} + \beta_3 BODM_{i,t} + \beta_4 COMPC_{i,t} + \beta_5 NOMC_{i,t} + \beta_6 BACE_{i,t} + \beta_7 BACNO_{i,t} + \beta_8 BACNED_{i,t} + \beta_9 BACM_{i,t} + \beta_{10} GENDIV_{i,t} + \beta_{11} FOREIGN_{i,t} + \beta_{12} BANKAGE_{i,t} + \beta_{13} OWNER_{i,t} + \beta_{14} PEER_{i,t} + \varepsilon_{i,t}$$

Where:

$Y_{i,t}$: Each of the dependent variables (ROA) as described in the table below:

Variable Symbol	Definition	Measurement
Dependent Variables		
$Y_{ROAi,t}$	The amount of return on bank's assets	Net income divided by total assets

β_0 : The intercept

$\beta_{1, 2, 3, \dots, 16}$: The percentage change in the dependent variable (ROA) caused by a 1 percent change in the independent variables

$\varepsilon_{i,t}$: The error term

Independent Variables		
Variable Symbol	Definition	Measurement
BODNO _{i,t}	Board size	Total number of board members
BODNED _{i,t}	Director independence	Number of non-executive members on the board divided by total number of board members
BODM _{i,t}	Number of board meetings per year	Number of board meetings held
COMPC _{i,t}	Compensation committee	If compensation committee exists = 1; If it does not = 0
NOMC _{i,t}	Nominations committee	If nominations committee exists = 1; If it does not = 0
BACE _{i,t}	Audit committee	If BAC exists = 1; If it does not = 0
BACNO _{i,t}	Number of audit committee members	Number of BAC members
BACNED _{i,t}	Number of audit committee non - executive members	Number of the non-executive members in BAC
BACM _{i,t}	Number of audit committee meetings per year	Number of BAC meetings
GENDIV _{i,t}	Board diversity by gender	Proportion of female directors in the board
FOREIGN _{i,t}	Foreign director	Proportion of non-Kenyan directors in the board
BANKAGE _{i,t}	Age of bank	15 years old or more = 1; less than 15 years old = 0
OWNER _{i,t}	Ownership	Local public commercial = 0, Local private commercial = 1, Foreign commercial=2
PEER _{i,t}	Peer group	Large = 2, Medium = 1, Small = 0

Pearson correlation analysis was used to examine the strength of relationship among the variables - both dependent and independent. Pearson correlation coefficient, a measure of linear association between two variables, assumes the data are normally distributed. The values of correlation coefficient range from -1 to 1. The sign of the correlation coefficient indicates the direction of the relationship (positive or negative).

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

The objective of this study was to determine the relationship between board structure and financial performance of commercial banks in Kenya. To achieve this objective the study applied descriptive statistics and inferential statistics, namely: correlation and regression analysis, to analyze the various board and control variables on the one hand, and the dependent variable (ROA) on the other hand.

This chapter presents data analysis and interpretation of the results. The areas covered in this chapter are: Descriptive Statistics, Correlation Analysis, Regression Analysis and Chapter Summary.

4.2 Descriptive Statistics

Data was collected from the 42 commercial banks which were operational in Kenya for the three years (2011, 2012 and 2013). One of the banks, Charterhouse Bank, which was in the initial population of 43, was left out because it has been under suspension by CBK and has not been operating from 2006 to date. Data collected in relation to board structure included: the number of directors; the proportion of non-executive directors; the proportion of female directors; the proportion of non-Kenyan directors; the number of board meeting held during the year; the existence of the compensation, nomination and audit committees; the size of the audit committee; the proportion of the non-executive directors in the audit committee; and the number of audit committee meetings held during the year. Additionally, data was collected in relation to the following control variables: bank age, ownership structure and peer group.

This section provides a summary of descriptive analysis of board structure and financial performance of commercial banks operating in Kenya from 2011 to 2013. The study used tables and figures to describe the variables of interest to this study.

4.2.1 Financial Performance of Commercial Banks

For the periods under study (2011, 2012 & 2013), the ROA of commercial banks in Kenya ranged between -13.6% and +10.4% with a simple average ROA for the three years being 2.9%. Table 4.1 below shows the average ROA for each of the three years.

Table 4.1: Commercial Bank Profitability

Year	ROA*
2011	2.93%
2012	2.54%
2013	3.01%

*ROA calculated on a simple average basis

Source: Research Findings

4.2.2 Board Structure of Commercial Banks

The minimum and maximum number of directors for commercial banks in Kenya during the period under study is 5 and 13 directors respectively. This means that all banks have complied with the CBK requirement of a minimum of 5 directors. Table 4.2 shows different the board sizes and the number of banks in each category of board size.

Table 4.2: Board Size

No. of Directors	Year					
	2011	% in 2011	2012	% in 2012	2013	% in 2013
5 - 7	20	48%	20	48%	22	52%
8 - 10	17	40%	18	43%	12	29%
11 - 13	5	12%	4	10%	8	19%
Total	42	100%	42	100%	42	100%

Source: Research Findings

The proportion of NEDs in Kenya ranges from 0% to 100% of the directors. On average, 74% of the directors during the period under study were NEDs. This is compliant with the CBK requirement that at least three-fifth of the directors be NEDS.

Board meetings per year ranged from 4 to 33, meaning all commercial banks met the CBK recommended good practice of holding board meetings at least quarterly. On average, directors hold 6 board meetings annually. Figure 4.1 shows the number of banks which had established compensation, nomination and audit committees for each of the three years in study.

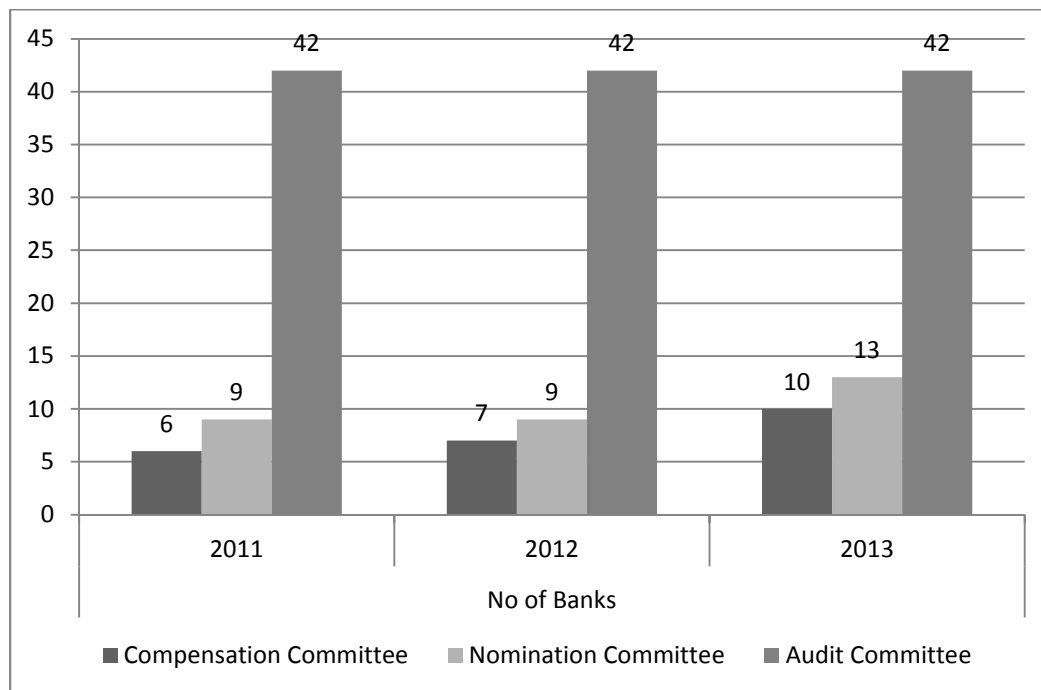


Figure 4.1: Board Committees

Source: Research Findings

In 2013, 10 of the 42 banks had constituted compensation/ remuneration committees while 13 had nomination committees. CBK has not made it mandatory for boards to have in place compensation and nomination committees. However, the number of banks that have compensation and nomination committees has been on the rise over the years. All commercial banks had BACs as required by CBK. BACs had a minimum of 2 members and a maximum of 7 members. The average size of BAC over the three years is 3 members. BACs on average were made up of 94% NEDs which is in compliance with the CBK requirement that the majority of BAC members should be NEDs.

The proportion of female directors in the boards ranges from 0% to 36%, with an average of 9.36% over the three years. The results show that about 4 additional female directors are admitted to boards of commercial banks every year. Figure 4.2 below shows the proportion and absolute number of female directors in commercial banks from 2011 to 2013.

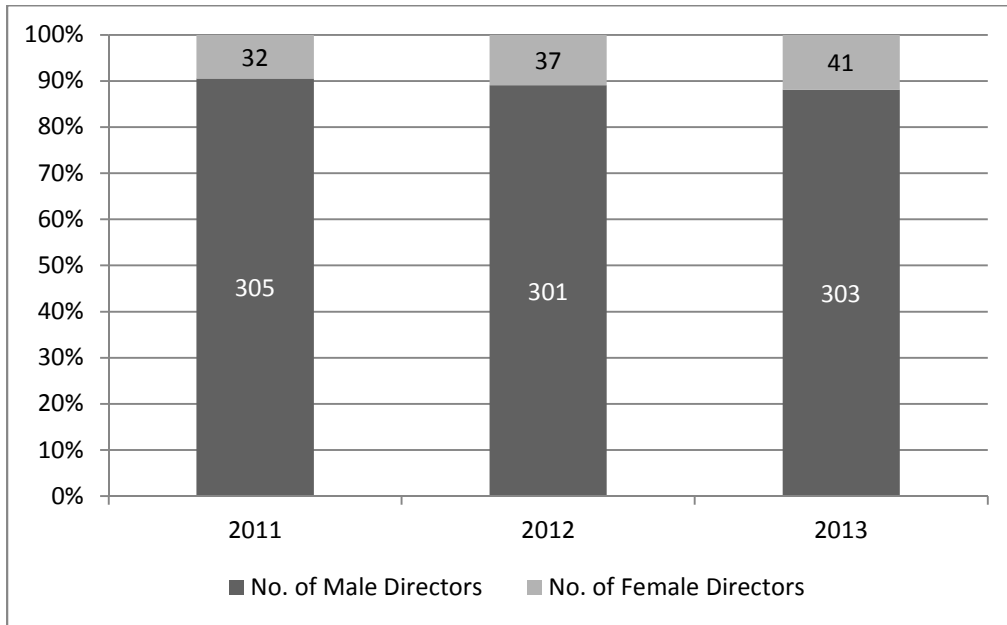


Figure 4.2: Proportion of Female Directors in Boards of Commercial Banks

Source: Research Findings

22% of the directors were non-Kenyan, mainly found in foreign owned commercial banks as illustrated in Figure 4.3.

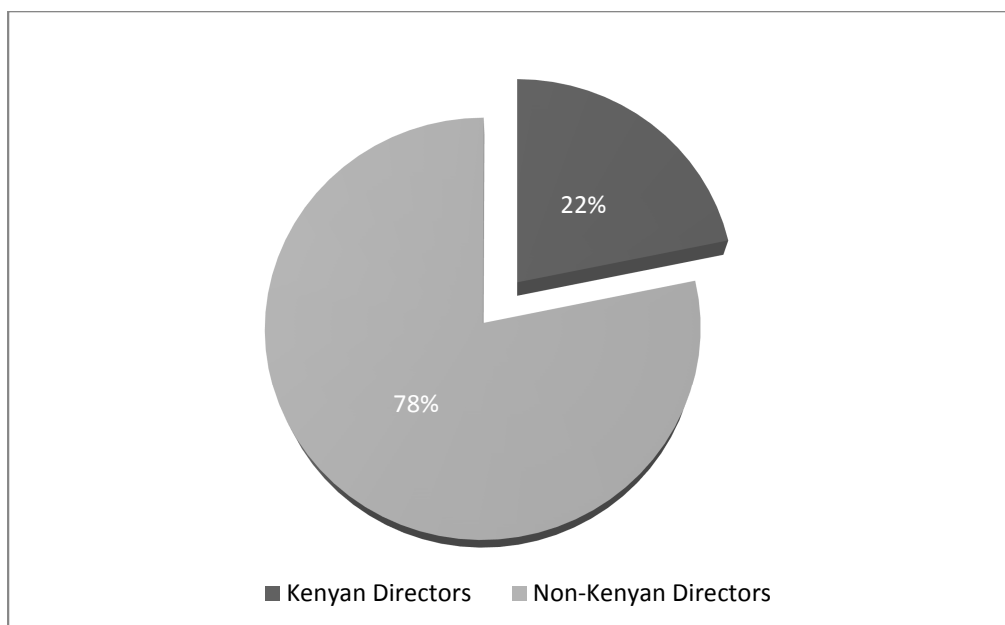


Figure 4.3: Proportion of Foreign Directors in Boards of Commercial Banks

Source: Research Findings

4.2.3 Other Determinants of Financial Performance of Commercial Banks

The average age of commercial banks in Kenya is 27.3 years. The oldest bank was noted to be 117 years. As shown in the table below, majority of Banks in Kenya (57%) are less than 20 years old. Table 4.3 below shows the age distribution of commercial banks.

Table 4.3: Age of Commercial Banks in Kenya

Bank Age	Frequency	Percent
1-20	24	57%
21-40	9	21%
41-60	6	14%
61-80	0	0%
81-100	1	2%
101-120	2	5%
Total	42	100%

Source: Research Findings

Majority of commercial banks in (60%) are local privately owned banks. 33% of the banks are have more than 51% shareholding by non-Kenyans. There are 3 local publicly owned commercial banks in Kenya. Table 4.4 shows the classification, number and proportion of each ownership category.

Table 4.4: Ownership Structure of Commercial Banks

Ownership	Frequency	Percent
Local Public Commercial Bank	3	7%
Local Private Commercial Bank	25	60%
Foreign Commercial Bank	14	33%
Total	42	100%

Source: Research Findings

There are 6 large banks, 14 medium banks and 22 small commercial banks in Kenya as shown on Table 4.5 below.

Table 4.5: Peer Groups of Commercial Banks in Kenya

Peer Group	Frequency	Percent
Large	6	14%
Medium	14	33%
Small	22	52%
Total	42	100%

Source: Research Findings

4.3 Correlation Analysis

In this study, correlation analysis was used to study the relationship among the various variables. Pearson correlation was used to study the relationship between the dependent variable and independent variables and among the independent variables.

The values of the correlation coefficient range from -1 to 1. The sign of the correlation coefficient indicates the direction of the relationship (positive or negative). The absolute

value of the correlation coefficient indicates the strength, with larger absolute values indicating stronger relationships.

The correlation coefficients presented in Table 4.6 indicate the variables that had significant, weak or no relationships. The correlation coefficients on the main diagonal are always 1.0, because each variable has a perfect positive linear relationship with itself. All the 42 banks established BACs; as such BAC existence (BACE) was constant and was therefore removed from the correlation matrix.

The results of the correlation analysis indicate strong positive relationship between the age of a bank (BANKAGE) and its peer group (PEER) and ROA. There is weak positive relationship between ROA and board size (BODNO), existence of a nomination committee (NOMC) and the proportion of female directors in the board (GENDIV). There exists weak negative relationship between ROA and the proportion of NEDS in the board (BODNED).

There is negligible relationship between ROA and number of board meetings (BODM), the existence of the compensation committee (COMPC), the size of BAC (BACNO), proportion of NEDs in BAC (BACNED), number of BAC meetings (BACM), the proportion of foreign directors (FOREIGN) and ownership structure (OWNER).

Other notable observation in the correlation matrix is the strong positive correlation between the nomination committee and the compensation committee, meaning a board that has a nomination committee is likely to also have a compensation committee. There exists strong positive correlation between the proportion of NEDs in the board and in BAC meaning a board with high proportion of NEDs is likely to have a high proportion of NEDs in BAC. Strong positive correlation also exist between bank ownership structure and proportion of foreign directors in the board, meaning foreign owned banks are more likely to have a high proportion of foreign directors in their boards than local private or local public commercial banks.

Strong positive correlation was noted between peer group and board size, which indicates that large banks will tend to have high number of directors than small banks. The strong positive correlation between peer group and bank age indicates that large banks tend to be old banks while small banks tend to be young.

The results of the correlation matrix were also subjected to multicollinearity test. Collinearity describes the situation where two or more variables in a statistical model are linearly related. If two explanatory variables are highly correlated with each other, they can cause problems during descriptive analysis because they are explaining almost the same variability in the outcome. It is therefore beneficial to examine relationship between explanatory variables and exclude highly correlated variables before conducting multivariable analysis. While there are no hard and fast rules about what cut-offs indicate a degree of multicollinearity, this study uses Pearson correlation, r , of less than 0.8 to indicate that the variables are not collinear. A look at the correlation matrix in Table 4.6 therefore shows very weak multicollinearity that would not jeopardize the validity of the analysis.

Table 4.6: Correlation Matrix

	YROA	BODNO	BODNED	BODM	COMPC	NOMC	BACNO	BACNED	BACM	GENDIV	FOREIGN	BANKAGE	OWNER	PEER
YROA	1	.291**	-.280**	.064	-.001	.286**	-.136	-.175*	.103	.256**	-.142	.430**	.063	.510**
BODNO	.291**	1	.064	.175	.294**	.436**	.436**	-.100	.127	.467**	-.123	.086	-.100	.619**
BODNED	-.280**	.064	1	.133	.184*	.189*	.080	.703**	.057	-.083	-.166	-.266**	-.398**	.023
BODM	.064	.175	.133	1	-.107	.163	.123	.127	.259**	.170	-.294**	.313**	-.321**	.179*
COMPC	-.001	.294**	.184*	-.107	1	.684**	.036	.139	-.076	.022	.090	.005	.105	.306**
NOMC	.286**	.436**	.189*	.163	.684**	1	.096	.167	-.015	.185*	-.013	.155	-.004	.480**
BACNO	-.136	.436**	.080	.123	.036	.096	1	-.168	-.008	.271**	.067	-.042	.008	.140
BACNED	-.175*	-.100	.703**	.127	.139	.167	-.168	1	.072	-.213*	-.077	-.038	-.277**	.050
BACM	.103	.127	.057	.259**	-.076	-.015	-.008	.072	1	.052	-.024	.435**	.008	.273**
GENDIV	.256**	.467**	-.083	.170	.022	.185*	.271**	-.213*	.052	1	-.112	.283**	.066	.373**
FOREIGN	-.142	-.123	-.166	-.294**	.090	-.013	.067	-.077	-.024	-.112	1	-.072	.528**	.047
BANKAGE	.430**	.086	-.266**	.313**	.005	.155	-.042	-.038	.435**	.283**	-.072	1	.182*	.524**
OWNER	.063	-.100	-.398**	-.321**	.105	-.004	.008	-.277**	.008	.066	.528**	.182*	1	.068
PEER	.510**	.619**	.023	.179*	.306**	.480**	.140	.050	.273**	.373**	.047	.524**	.068	1

** . Correlation is significant at the 0.01 level (2-tailed). * . Correlation is significant at the 0.05 level (2-tailed).

Source: Research Findings

4.4 Regression Analysis

The regression model adopted in this study is shown below:

$$\text{ROA} = \beta_0 + \beta_1\text{BODNO} + \beta_2\text{BODNED} + \beta_3\text{BODM} + \beta_4\text{COMPC} + \beta_5\text{NOMC} + \beta_6\text{BACE} + \beta_7\text{BACNO} + \beta_8\text{BACNED} + \beta_9\text{BACM} + \beta_{10}\text{GENDIV} + \beta_{11}\text{FOREIGN} + \beta_{12}\text{BANKAGE} + \beta_{13}\text{OWNER} + \beta_{14}\text{PEER} + \varepsilon$$

Where:

ROA	: The amount of return on bank's assets
BODNO	: Board size
BODNED	: Director independence
BODM	: Number of board meetings per year
COMPC	: Compensation committee
NOMC	: Nominations committee
BACE	: Audit committee
BACNO	: Number of BAC members
BACNED	: Proportion of NEDs in BAC
BACM	: Number of BAC meetings per year
GENDIV	: Board diversity by gender
FOREIGN	: Foreign director
BANKAGE	: Age of bank
OWNER	: Ownership
PEER	: Peer group
β_0	: The intercept
$\beta_{1...14}$: The percentage change in the dependent variable caused by a 1% percent change in the independent variables
ε	: The error term

Table 4.8 displays R, R squared, adjusted R squared and the standard error. R is the correlation between the observed and predicted values of the dependent variable. The values of R range from -1 to 1. The sign of R indicates the direction of the relationship - positive or negative. The absolute value of R indicates the strength of the relationship,

with larger values indicating stronger relationships. R squared is the proportion of variation in the dependent variable explained by the regression model. The values of R squared range from 0 to 1. Small values indicate that the model does not fit the data well. Adjusted R squared attempts to correct R squared to more closely reflect a good fit of the model.

Table 4.8 below shows R, which is the correlation between the observed and predicted values of the dependent variable, to be 0.712. R square, which is the proportion of variation in the dependent variable, is 0.507. The adjusted R square is 0.449, showing the relationship between the observed and predicted values of the dependent variable. This indicates that PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED and BODNO account for 44.9% of the financial performance of commercial banks as indicated in table below.

Table 4.7: Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.712 ^a	.507	.449	.022176

a. Predictors: (Constant), PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED, BODNO

Source: Research Findings

4.4.1 Analysis of Variance

ANOVA table shows results of analysis of variance, sum of squares, degree of freedom (df), mean square, regression and residual values obtained from regression analysis. From Table 4.9 below, the mean square - which is the sum of squares divided by the degrees of freedom - was 0.004. The F static, which is regression mean square divided by the residual mean, was 8.845. Degree of freedom (df) was 0.004. Statistically, the overall relationship was significant with significant value, P value = 0.000, (P < 0.05) as shown below.

Table 4.8: ANOVA Analysis

Model ^a	Sum of Squares	df	Mean Square	F	Sig.
Regression	.057	13	.004	8.845	.000 ^b
Residual	.055	112	.000		
Total	.112	125			

a. Dependent Variable: YROA

b. Predictors: (Constant), PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED, BODNO

Source: Research Findings

4.4.2 Regression Coefficients

Coefficient of independent variables (PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED and BODNO) and the dependent variable (ROA) are presented in table 4.9 below. Five predictors - COMPC, NOMC, BACNO, FOREIGN and PEER – were found to be significant in predicting financial performance since their significance values were less than 0.05. The other predictors (BODNO, BODNED, BODM, BACNED, BACM, GENDIV, BANKAGE and OWNER) were considered not significant since their significance values were greater than 0.05 as shown in Table 4.10 below.

Interpreting the values of beta (β) coefficients, it means that holding all other independent variables constant, every unit change on BODNO, NOMC and PEER increases financial performance by 0.001, 0.025 and 0.017 respectively. On the other hand, every unit change in BODNED, BODM, COMPC, BACNO, BACNED, BACM, and FOREIGN will reduce financial performance by -0.029, -0.001, -0.026, -0.007, -0.009, -0.001, and -0.021 respectively. A unit change in GENDIV, BANKAGE or OWNER has no effect on financial performance.

Table 4.9: Regression Coefficients

Model ^a	Unstandardized		Standardized	t	Sig.	Collinearity Statistics	
	Coefficients		Coefficients				
	B	Std.	Beta			Tolerance	VIF
(Constant)	.076	.019		3.988	.000		
BODNO	.001	.002	.085	.727	.469	.323	3.100
BODNED	-.029	.016	-.216	-1.796	.075	.305	3.274
BODM	-.001	.001	-.135	-1.647	.102	.660	1.515
COMPC	-.026	.008	-.343	-3.499	.001	.458	2.183
NOMC	.025	.007	.357	3.403	.001	.399	2.505
BACNO	-.007	.003	-.214	-2.649	.009	.678	1.475
BACNED	-.009	.015	-.068	-.620	.537	.370	2.702
BACM	-.001	.002	-.054	-.676	.501	.693	1.443
GENDIV	.000	.022	-.002	-.020	.984	.644	1.554
FOREIGN	-.021	.010	-.178	-2.080	.040	.599	1.669
BANKAGE	.000	.000	.136	1.194	.235	.339	2.948
OWNER	.000	.005	.003	.036	.972	.536	1.865
PEER	.017	.005	.407	3.410	.001	.309	3.232

Source: Research Findings

The resultant equation for this model is:

$$\text{ROA} = 0.076 - 0.026\text{COMPC} + 0.025\text{NOMC} - 0.007\text{BACNO} - 0.021\text{FOREIGN} + 0.017\text{PEER}$$

Table 4.11 also shows measures of multicollinearity. Multicollinearity occurs when more than two predictor variables are inter-correlated. A good regression model should be free from inter-correlation between variables. The study relied on the value of variance inflation factor (VIF) as the measure of multicollinearity. VIF value below 10 and tolerance value above 0.1 indicates that there is no multicollinearity among independent variables. From Table 4.11, the tolerance values were below 10 and VIF values for each variable were greater than 0.1, which means that multicollinearity did not exist among the predictor variables.

4.5 Chapter Summary

The analysis shows that commercial banks in Kenya have met CBK requirements in as far as board size, board meetings and BAC composition are concerned. All the banks had a minimum of 5 directors and each has established BAC, with a majority of BAC directors being NEDs. At a minimum board meetings were held quarterly. The average proportions of female directors and non-Kenyan directors in the board were 9.36% and 22% respectively. Majority of the banks had been in existence for less than 20 years and were locally owned private institutions.

Correlation analysis of the data indicates strong positive relationship between BANKAGE and PEER and ROA. Weak positive relationship exists between ROA and BODNO, NOMC and GENDIV. Relationship between ROA and BODNED is weak and negative. The relationship between ROA and BODM, COMPC, BACNO, BACNED, BACM, FOREIGN and OWNER is negligible. Other notable observations in the correlation analysis are the strong positive relationships between NOMC and COMPC; BODNED and BACNED; OWNER and FOREIGN; PEER and BODNO; and PEER and BANKAGE.

Regression analysis statistics show that PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED and BODNO account for 44.9% of the financial performance of commercial banks. The analysis showed five independent variables - COMPC, NOMC, BACNO, FOREIGN and PEER - to be significant predictors of bank financial performance. Other variables - BODNO, BODNED, BODM, BACNED, BACM, GENDIV, BANKAGE and OWNER - were found to be insignificant predictors of ROA.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of findings, conclusions and recommendations from the study. The chapter also highlights various limitations of this study and makes suggestions for further research. The chapter is organized into: Summary of Findings, Conclusion and Recommendations, Limitations of the Study and Suggestions for Further Research.

5.2 Summary of Findings

The objective of the study was to investigate the relationship between board structure and financial performance of commercial banks in Kenya. The study makes a number of findings. Commercial banks in Kenya operate within the corporate governance guidelines and have met the minimum CBK requirements as far as board size, board meetings and BAC composition are concerned. Each of the commercial banks had a minimum of 5 directors and had established BAC. It is notable that majority of directors in BAC were NEDs and board meetings were held, at the very least, on quarterly basis.

Boards of commercial banks are male dominated; the average proportion of female directors was 9.36%. Non Kenyans make up 22% of directors in commercial banks. Majority of the banks (58%) had been in existence for less than 20 years as at December 2013. 60% of commercial banks operating in Kenya were locally owned private institutions.

The results of correlation analysis indicate strong positive relationship between BANKAGE and PEER and ROA. This means that older banks perform well financially compared to young banks and that it takes some time for banks to realize decent ROA. Large banks – large in terms of weighted composite index that comprises assets, deposits, capital, number of deposit accounts and loan accounts - have higher ROA than smaller banks.

The study found out existence of weak positive relationship between ROA and BODNO, NOMC and GENDIV. This means that an increase in board size and proportion of female directors result in an increase in ROA. Similarly establishment of a nomination committee by the board would increase a bank's ROA. Conversely, an increase in the number of non-executive directors in the board would result in decreased ROA. This study therefore agrees with proponents of the stewardship theory who argue that executive-dominated boards should be favoured for their depth of organizational knowledge, access to current operating information, technical expertise and commitment to the firm (Letting' et al., 2012; Muth & Donaldson, 1998).

The study found negligible relationship between ROA and BODM, COMPC, BACNO, BACNED, BACM, FOREIGN and OWNER. Other notable observations in the correlation analysis are the strong positive relationships between NOMC and COMPC; BODNED and BACNED; OWNER and FOREIGN; PEER and BODNO; and PEER and BANKAGE. What this means is that a board that has a nomination committee is likely to also have a compensation committee and that a board that has a high number of non-executive directors would also have a high proportion of non-executives in BAC. Similarly, foreign owned banks are likely to have a high proportion of non-Kenyan directors. Large banks tend to have a high number of directors and are more likely to be older than small banks.

Regression analysis statistics showed that PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED and BODNO account for 44.9% of the financial performance of commercial banks. From the analysis, five independent variables - COMPC, NOMC, BACNO, FOREIGN and PEER - were found to be significant predictors of bank financial performance. The other variables - BODNO, BODNED, BODM, BACNED, BACM, GENDIV, BANKAGE and OWNER - were found to be insignificant predictors of ROA. Variance inflation factor and tolerance values proved no multicollinearity on the independent variables.

Interpreting the beta coefficients (β) of significant predictors shows that, holding all other independent variables constant, every unit change on NOMC and PEER increases ROA by 2.5% and 1.7% respectively. On the other hand, every unit change in COMPC, BACNO and FOREIGN reduces ROA by 2.6%, 0.7% and 2.1% respectively. This means that establishing a nomination committee and ensuring that banks are well capitalized will significantly improve financial performance of banks. Conversely, establishing a compensation committee, increasing the number of directors in BAC and increasing the number of foreign directors in the board all have negative impact on a bank's financial performance.

5.3 Conclusion and Recommendations

Board structure plays a key role in determining financial performance of commercial banks as demonstrated by the finding that PEER, BODNED, BACNO, FOREIGN, BACM, COMPC, BODM, GENDIV, OWNER, BANKAGE, NOMC, BACNED and BODNO account for about 45% of ROA. Of all the variables in study only COMPC, NOMC, BACNO, FOREIGN and PEER significantly determine financial performance.

Of all the board variables under study, only establishment of a nomination committee has significant positive impact on ROA. Nomination committee of the board is responsible for considering matters relating to the composition of the board, including the appointment of new directors and making appropriate recommendations to the board and reviewing succession plans to maintain an appropriate balance of skills on the board. The committee's responsibilities also include corporate governance issues such as overseeing the annual board effectiveness reviews, reviewing the board's remuneration, the board charter, conflicts of interest register and ensuring appropriate ongoing training for the board.

Establishing a compensation committee significantly reduces financial performance of commercial banks. A possible explanation of this could be that compensation committees make compensation (salaries, wages and benefits) to be a major agenda of the board. As

such, the board spends more of its time on discussions around compensation and less time discussing other important matters such on strategy and financial growth.

The proportion of non-executive directors in the board and BAC does not seem to be of any statistical significance in determining financial performance; although the correlation analysis indicates a negative inverse relationship between the BODNED and BACNED. Increasing the number of directors in BAC has significant negative impact on ROA. This could be attributed to the fact that most directors in BAC predominantly come from finance and accounting background. An increase therefore in BAC size only results in cost increase without corresponding increase in financial value to the bank.

Although there is a weak positive association between ROA and BODNO (Pearson correlation of 0.291 which is significant at the 0.01 level), BODNO was not found to be a significant predictor of financial performance. This means that recruitment of a single director to the board will not significantly lead to an increase in ROA. This suggests that new directors would take some time before making any meaningful contribution that would result in improvement in ROA.

The number of meetings held by the full board or BAC has negligible relationship with financial performance. A high number of board or BAC meetings, therefore, will not necessarily translate to improved financial performance. Although CBK has recommended that majority of BAC members be independent directors, and the analysis finds that indeed majority of the banks have met this requirement, this study finds negligible relationship between ROA and the proportion of non-executives in BAC. Similarly, the relationship between ownership structure and ROA is very weak.

Whilst CBK guidelines seek to ensure that boards are properly constituted and appropriately diverse, this study finds gender diversity as having no significance in determining financial performance of banks. This study however acknowledges diversity is a broad concept and includes other facets of boards, such academic qualifications,

technical expertise, relevant banking knowledge, experience, nationality and age which were not considered by this study.

Recruiting more foreigners to the board significantly reduces ROA. This could be because foreign directors lack knowledge of local realities and dynamics and will have little or no meaningful contribution to make in their first years.

Another determinant of financial performance of banks, other than board structure, is bank size - measured by bank's peer grouping. Large banks, most of which are old banks, perform better than small banks financially. This means that it takes quite some time for banks to acquire assets, be well capitalized and before they can register high levels of ROA. The results of this study are consistent with past researches by Short (1979), Bikker and Hu (2002) and Goddard et al. (2004) which conclude that large size banks are more profitable than small banks.

While the age of a bank has positive relationship with ROA, a one year increase in the age of a bank has no impact on ROA. This means that it takes a bit of time for banks to realize positive returns from its assets. Similarly, recruitment of one additional female director to the board has no impact on financial performance.

This study sought to add value to the literature on financial performance and commercial banks in Kenya by providing insight into a significant determinant mostly associated with bank performance – namely, board structure. This study therefore makes a number of recommendations.

First, establishment of nomination committees is very important to be left as optional by banks. Policy makers should consider making it mandatory for banks to establish nomination committees. Currently the number and nature of committees depends on many factors, including the size of the bank and its board, the nature of the business areas of the bank, and its risk profile. Only BAC, board risk management committee and board

credit committee are mandatory. The nomination committees should be well constituted and have clear terms of reference.

Second, boards should consider establishing ad hoc compensation committees, rather than permanent compensation committees, to deal with compensation matters as and when they arise. This is so as not to give compensation matters prominence in board agenda and organizational discussions.

Third, increasing the number of directors in BAC is counterproductive as BAC members tend to have similar skills. An increase in the number of the directors would not be financially beneficial to boards and as such boards should ensure they have lean sizes of BAC.

Fourth, boards should stick to the statutorily set number of meetings, if for anything to meet the regulatory requirements and reduce the cost of compliance. This study finds it adequate for full board and BAC to hold quarterly meetings, unless there are extraneous circumstances for additional meetings.

Fifth, Boards, and more so boards of foreign owned banks, should not increase the number of foreign directors. This study recommends that boards should set up nomination committees, where these committees do not already exist, and task the committee with the responsibility of recruiting local directors who have a better understanding of Kenya's banking sector.

Sixth, policy makers should set up higher capital requirements for banks. This would drive small to medium size banks to merge or seek other capital raising initiatives in order to meet the required capitalization requirements. This way, banks will increase their asset base, deposits, and number of deposit and loan accounts which would result in improved financial performance.

Finally, the findings from this study suggest that policy makers should strike a balance between benefits and costs of corporate governance.

5.4 Limitations of study

A study of this nature has certain inherent limitations as it is designed to investigate into, and understand, specific elements. The findings of this study cannot be generalized to all sectors and industries since the sample was limited to banks operating in Kenya and excluded all other banks operating elsewhere.

The study was also limited to the aforementioned specific elements and variables; therefore, it cannot be generalized to all other elements and variables of the banking industry.

The study covered only one financial year after the introduction of the 2012 Prudential Guidelines by CBK. This period is not sufficient to study how various board variables will evolve over time, and what significance such changes will have on financial performance.

The study concerns commercial banks operating in Kenya only. The findings therefore cannot be generalized to other jurisdictions since each country has its own characteristics and circumstances.

5.5 Suggestions for further studies

There is merit in extending this study to cover other institutions regulated by CBK. These institutions are: mortgage companies, microfinance banks, credit reference bureaus and forex bureaus. Future research should consider building more control variables into the model.

A similar study should be conducted in no less than five years from now to confirm if indeed similar conclusions can be drawn about the relationship between board structure

and financial performance. This is drawn from the fact that this study was done rather soon after the introduction of the 2012 Prudential Guidelines.

The conclusions of this study suggest the need for further research regarding board committees, particularly nomination committee. There is need to study various aspects of the committees and their impact on financial performance. The study could also be extended to cover the following committees, which were not in scope of this study, namely: board risk management committee and board credit committee.

Comparative research could be conducted to study board composition of banks regulated by both CBK and CMA to gauge if there are any significant differences in the two regulatory regimes and to find out which of the two is more effective. Further research can be conducted to study the relationship between board structure and financial performance of development finance institutions (DFIs) in Kenya.

An area of board that is gaining prominence is board and director evaluation. CBK has made it mandatory for banks to conduct board evaluation and to file a report annually. A study should be conducted to find out the current board, committee and individual director evaluation practices in Kenya and what effect these practices have on financial performance.

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APPENDICES

Appendix I: Introduction Letter



UNIVERSITY OF NAIROBI
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DATE 27 AUGUST 2014

TO WHOM IT MAY CONCERN

The bearer of this letter PAUL EKENO KORIANG

Registration No: DG1/70227/2009

Is a Master of Business Administration (MBA) student of the University of Nairobi.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate if you assist him/her by allowing him/her to collect data in your organization for the research.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.


PARTRICK NYABUTO
MBA ADMINISTRATOR



Appendix III: List of Commercial Banks in Kenya

#	Bank Name
1	African Banking Corporation Ltd
2	Bank of Africa (K) Ltd
3	Bank of Baroda (K) Ltd
4	Bank of India
5	Barclays Bank of Kenya Ltd
6	CFC Stanbic Bank (K) Ltd
7	Charterhouse Bank Ltd
8	Chase Bank Ltd
9	Citibank N.A. Kenya
10	Commercial Bank of Africa Ltd
11	Consolidated Bank of Kenya Ltd
12	Co-operative Bank of Kenya Ltd
13	Credit Bank Ltd
14	Development Bank of Kenya Ltd
15	Diamond Trust Bank (K) Ltd
16	Dubai Bank Ltd
17	Ecobank Kenya Ltd
18	Equatorial Commercial Bank Ltd
19	Equity Bank Ltd
20	Family Bank Ltd
21	Fidelity Commercial Bank Ltd
22	First Community Bank Ltd
23	Giro Commercial Bank Ltd
24	Guaranty Trust Bank Ltd
25	Guardian Bank Ltd
26	Gulf African Bank Ltd
27	Habib Bank A.G. Zurich
28	Habib Bank Ltd
29	I&M Bank Ltd
30	Imperial Bank Ltd
31	Jamii Bora Bank Ltd
32	K - Rep Bank Ltd
33	Kenya Commercial Bank Ltd
34	Middle East Bank (K) Ltd
35	National Bank of Kenya Ltd
36	NIC Bank Ltd
37	Oriental Commercial Bank Ltd
38	Paramount Universal Bank Ltd
39	Prime Bank Ltd
40	Standard Chartered Bank (K) Ltd
41	Trans - National Bank Ltd
42	UBA Kenya Ltd
43	Victoria Commercial Bank Ltd

Source: Central Bank of Kenya (December, 2013)