

# **CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF SELECTED COMMERCIAL BANKS LISTED AT NAIROBI SECURITIES EXCHANGE IN KENYA**

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## **ABSTRACT**

Performance of commercial banks has been impressive in terms of profits in the last few years. This may be as a result of good governance in the banking sector. The study examined the Corporate Governance factors and Financial Performance of commercial banks listed in Nairobi Securities Exchange in Kenya. Specifically, the study examined the effects of board size, board independence, level of education of board members, ethnic composition and gender diversity of board members on financial performance. The performance of the firm was measured using Return on equity, Return on asset and Net interest margin. A cross sectional and analytical research design was used in this study. The population involved in this study is 11 commercial banks commercial banks listed in the Nairobi Securities Exchange in Kenya. Purposive sampling was used to obtain sample representation of the entire population. In this case, 5 of the 11 Chief Executive Officers from the banks were

interviewed. Primary data was obtained by administering questionnaires to Chief Executive Officers and Senior Management Officers of the sampled banks. The content validity of the two instruments of data collection was assured by ensuring that each of the items in the questionnaire and interview schedule addresses specific contents and objectives of the study. Statistical Package for Social Scientists was used and Spearman Correlation Coefficient and Multiple Regression Analysis to determine the magnitude of the relationship and prediction of financial performance respectively was applied. From the study we can therefore conclude that size of the board, board independence, level of education of board members, gender diversity, and ethnic composition positively influence the financial performance of commercial banks listed to a great extent.

**Key Words:** *corporate governance, financial performance, net interest margin, return on equity, NSE*

## **INTRODUCTION**

In the banking industry, corporate governance involves the way banking institutions business and affairs are managed by the board of administration and the top management, which affects how the bank works out the bank's objectives, plans and policies, taking into consideration making appropriate economic returns for founders and other shareholders, day-to-day work management, protection of the rights and interests of recognized stakeholders (shareholders and depositors), companies' commitment to sound and safe professional behaviors and practices which are in conformity with regulations and legislations (Linyiru, 2006).

Corporate governance is a multi-faced subject. An important theme of corporate governance deals with issues of accountability and fiduciary duty, essentially advocating the implementation of guidelines and mechanisms to ensure good behavior and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should

aim to optimize economic results, with a strong emphasis on shareholder's welfare. There are yet other sides to the corporate governance subject, such as the stake holder's view, which calls for more attention and accountability to players other than the shareholders e.g. the employees or the environment, (Awino, 2011). Recently there has been considerable interest in the corporate governance practices of modern corporations, particularly since the high-profile collapses of large U.S. firms such as Enron Corporation and WorldCom (Nambiro, 2007).

The determinants of bank performances can be classified into two categories, namely bank specific (internal) and macroeconomic (external) factors (Al-Tamimi, 2010; Aburime, 2005). These are stochastic variables that determine the output. Internal factors are individual bank characteristics which affect the banks performance. These factors are basically influenced by internal decisions of management and the board. These factors are within the scope of the bank to manipulate them and that they differ from bank to bank. These include capital size, size of deposit liabilities, size and composition of credit portfolio, interest rate policy, labor productivity, and state of information technology, risk level, management quality, bank size, ownership and the like.

The external factors are sector-wide or global factors which are beyond the control of the company and affect the profitability of banks. The macroeconomic policy stability, Gross Domestic Product, Inflation, Interest Rate and Political instability are also other macroeconomic variables that affect the performances of banks. For instance, the trend of GDP affects the demand for banks asset. During the declining GDP growth the demand for credit falls which in turn negatively affect the profitability of banks. On the contrary, in a growing economy as expressed by positive GDP growth, the demand for credit is high due to the nature of business cycle. During boom the demand for credit is high compared to recession (Athanasoglou et al., 2005). The government owned bank for instance, suffers incessant/frequent changes in board membership and many appointments are made based on political affiliation rather than expertise consideration. Consequent upon this, board members view themselves as representative of political parties in sharing the national cake emanating thereof and thus ascribe their loyalty to the party members rather than the proper running of the bank itself. On the side of the privately owned banks, shareholders constitute the problem. As a result of the insiders abuse of recruiting inexperienced and incompetent personnel to hold key positions in the bank, deterioration of management culture and weak internal control system instigated by the squabbles among the high ranking management decision making team and non-compliance with laws and prudential standards, mismanagement seemed to play a major role in bank failure in Kenya. Bank losses increases and management resorts to hiding the losses in order to buy time and remain in control (Ogumu, 2006).

The banking industry being the nerve centre of the economy is invariably affected by economic and political environment/condition of the country. For instance, the Structural Adjustment Programme (SAP) introduced in 1986 led to a wide range of economic reforms that affected the banking system. Also political situation like the political crisis like the disputed election in

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

## **STATEMENT OF THE PROBLEM**

Corporate governance should be enriched by expanding the framework of analysis beyond the conventional criteria to incorporate the norms and values. Such considerations can improve our understanding of board room dynamics and the characteristics of the decision management and decision control, (Wainaina, 2003). From the published annual financial reports, commercial banks in Kenya recorded unpleasant performance in the early 2000 thus affecting the investors' confidence in the banking sector. Profit margins for these commercial banks have been increasing marginally for the last five years and this study is therefore designed to establish the effect if any of corporate governance on financial performance of Commercial Banks listed in Nairobi Securities Exchange. A number of studies have also been carried out in the area of corporate governance and financial performance in state corporations and in cooperative societies, examples; Njoka, (2010); Linyiru, (2006); Maina, (2006); Awino, (2011); Muriiti, (2011) and Ooko, (2011). There is a wide gap that exists since none of them covers effects on board size, board independence, level of education, ethnic composition, gender diversity and performance specifically in the commercial banking sector in Kenya. It was against this background that the researcher found it necessary to carry out a study on corporate governance and its effects on performance in the Kenyan commercial banking sector to bridge the gap that existed.

## **GENERAL OBJECTIVE**

The objective of this study is to investigate effects of corporate governance on financial performance of Commercial Banks listed in Nairobi securities exchange.

## **RESEARCH HYPOTHESIS**

H01: There is no significant relationship between board size on financial performance of commercial banks listed in Nairobi Securities Exchange

H02: There is no significant relationship between ethnic composition on financial performance of Commercial Banks listed in Nairobi Securities Exchange

## **THEORETICAL REVIEW**

### **Agency Theory**

Lots of empirical work has been done on CG on theoretical perspectives of agency theory because it has theoretical roots in it (Filatotchev and Wright, 2011). Agency theory was proposed by Alchian and Demsetz in field of Economics, directed at the agency relationship, in which one party (principal) delegates work to another (agent), who performs that work (Alchian and Demsetz, 1972; Eisenhardt, 1989). It discusses that shareholders' interests necessitate security by split-up incumbency of the role of board and CEO (Donaldson and Davis, 1991). The segregation of management role and ownership lead to a serious matter of control over the risk attitude (Berle and Means, 1934). The basis of the theory is on mechanism where board of directors and owners act as the monitoring authority whereas agents are the managers (Mallin, 2004). The disadvantage of the framework is that agent may not work for paramount interest of principal. Agent misusing his/her power for monetary and non-monetary benefits. Agent doesn't take precautionary risk measures or agent and principals may have different attitude towards risk. It explains the behaviour of persons in firms in their own self-interest, if it is not govern to minimize this behaviour. Agency problem arises because contracts are written and enforced by considering costs. There are agency costs to demoralize agents from benefiting at the expense of principals (Alexander, 2010). Agency costs include the costs of structuring, monitoring and bonding a set of contracts among agents of divergent interests (Fama and Jensen 1983).

Principal-agent theory specifies mechanism which reduces agency loss (Eisenhardt, 1989). This includes incentives (equity-based) to management for maximising shareholder interest and aligns the interest of principals and agents (Filatotchev and Wright, 2011; Jensen and Murphy, 1990). Various agency researchers have discussed the governance mechanism to protecting the shareholders interest and alignment of principal and agent liaison. Although the major emphasis given on the monitoring dimension of governance (Filatotchev and Wright, 2011). The "model of man" underlying agency is based on self-interested actor those aims at the maximising their own personal gain. The model is individualistic and in-built conflict of interest among owner and managers always stand. This model is called by organizational psychologists as Theory X (Mcgregor, 1960). Corporate Governance issues crop up whenever there is an agency problem (misalignment of interest, conflict of interest) among the parties of the organization (Eisenhardt, 1989; Fama, 1980; Ross, 1973). This misalignment of interest crop up due to the divergent goals, priorities and information asymmetries (Gamble et al., 2013). Second issue, the transaction costs are such that the agency problem cannot be dealt with contract (Hart, 1995). The theme behind the agency theory is aligning the interests of owners and management (Jensen and Meckling, 1976; Fama and Jensen, 1983) and to resolve two problems that crop up in agency relationship. The first problem appears when there is conflict between the principal's desires and agent's desire. The second problem is when principal cannot validate whatever agent is doing. Early perspectives on CEO-directors relationship (fiduciary relationship) was on the base of agency theory.

According to the theory, directors monitor the decisions and performance of the top management. The top management gives valuable information that enables the directors to monitor them efficiently (Fama and Jensen, 1983). The agency role of the directors serves as a governing function which translates into the interests of the shareholders. They not only approved the decisions made by the managers but also monitor its implementation over the time period. It has been investigated in vast majority of literature (Daily and Dalton, 1994).

Therefore, theory is normally used to predict the behaviour of the management. However, critics have clarified that agency theory and its applications is Anglo-American specific (Phan and Yoshikawa, 2000). The board structure, process and board management relationship is based on agency theory view of CG firms (Kaplan, 1995; Kaplan and Minton, 1994). Scholars in the field of CG moved forward the simple solutions often suggested in studies conducted on the basis of agency theory (Filatotchev and Wright, 2011; Westphal, and Zajac, 2013). According to Jensen et al., (2004) (as cited by Benz and Frey, 2007), that agency theory failed to examine the rational reaction of top management subjected to pay-for-performance. Agency theory is a control based theory and its supporters recognized that the CG mechanisms need to be described so that top management self-interest is accommodated (Jensen and Meckling, 1976). Furthermore, it focuses on the link between the board independence or leadership structure and firm performance.

### **Stakeholder Theory**

Stakeholder theory is mainly developed to identify, analyze, develop and manage strong coordination among the stakeholders (Freeman, 1984). It is in juxtaposition to agency theory. In agency theory, the maximizing the shareholders' wealth is paramount, whereas the stakeholder theory focuses on wider stakeholders groups. Now a day, many corporations endeavor to maximize shareholder wealth whilst at the same time emphasizing on range of other stakeholders. The theory is prominent corporate governance theory because of the accountability of the firm to a wider audience than simply its shareholders. The theory suggests that the performance of corporate cannot be measured only in term of gain to its shareholders (Jensen 2001). Shareholders and stakeholders encourage distinct CG structures and monitoring mechanism. For example, Anglo-American model emphasizing on shareholders' value and board consists of executives and non-executive directors. Whereas, in German model, stakeholders have constitutional right allow representatives to actively participate in board meetings, sit on the supervisory board alongside the directors. Theory and empirical work often do not ensure which corporate governance structure would be most efficient (Bebchuk & Roe, 1999).

### **Stewardship Theory**

Stewardship theory is alternative to agency theory in term of managerial motivation. It explains how shareholders' interests are maximized through stockholder tenure in the roles of board chair and CEO (Donaldson and Davis, 1991). They stated that it focuses on the proportion of insiders on board to analyze link with firm performance. Dalton and Kesner (1987) highlighted that about 8 percent USA firms has CEOs who are board chair too. This duality proportion is very common

in USA compared to other countries like Japan (Kesner and Dalton, 1986) and Australia (KornFerry, 1988) and highly criticized. The executive members are far from being opportunistic shirker. Their aim to do work effectively and efficiently and to be great steward of the assets they are controlling within corporation. The theory holds the notion that there is no hidden dispute or trouble of top management's motivation.

Stewardship theory is that the managers, left on their own, will indeed act as responsible stewards of the assets they control (Davis et al., 1997). In theory, the model of man (agent) is grounded on a steward. Their behavior is pro-organizational and collectivistic. The logic behind is that stewards main aim to achieve the objectives of the organizations. This behaviour ultimately beneficial for principals in terms of increased in share prices and return on shares. Theory assist that board and management are single, collective stewardship team. Board or stewards basically support and assist the management and CEO. Stewardship philosophers expect a significance association between the growth of the firm and stockholder's well-being. Unlike most theories of corporate governance and Agency theory which focuses individual work for self-interest at the expense of owners. The stewardship theory rejects this notion. In stewardship theory the agent is self-actualizing focused on higher order needs (achievement and self-actualization). They place the firm ahead of their personal interest. The stewards are involvement-oriented and trusty. The stewards do not primarily target "survival" needs. No doubt human must have income to survive. The theory is best applicable in low-power distance culture. It argues that agents inherently seek to do good job. They don't treat themselves as outer employees instead they treated themselves important member of the firm.

They align own psyche and way of work with the prestige of the corporation. The relevance of stewardship theory to Corporate Governance manager needs to be given clear and unambiguous role. The organizational structure should give and support acceptable authority, worth and power to the management. This is why the stewards are referred to as the company man .i.e. man who will be committed and pace the firm ahead of his self-interests. This theory gives different angle than agency theory, in which top management are expected to act for self-interests at the expense of shareholders.

### **Resource Dependency Theory**

Resource dependency theory (RDT) draws from both sociology and management (Pettigrew, 1992), states that how the external resources of the firm affect the behaviour of the firm and takes a strategic view of CG.

Therefore, the acquisitions of external resources are vital for strategic management of any organization. Every corporation depends on the resources. Hence, RDT recognized that the administrative body of any firm as the linchpin among the firm and the resources that are required to accomplish the goals (Tricker, 2012).

The resources emanate from the environment consist of other firms. We can say that the resources are in the hand of other firms. Therefore, firms are depending on each other and exchange resources. This is why resources are the basis of power for firms because the resources are valuable, costly to imitate, rare and not substitutable (Hitt et al., 2012). In other words, resources and power are directly linked. Those firms who have resources can be considered more powerful as compared to its competitors those don't have access to that. The dependence on other firms normally affects the productivity of firms. The scarcity of resources leads to uncertainty for organizations. Firms always seek to find ways to exploit the resources for the safeguard of its own long term survival. The resource dependency theory investigates the association between directors interlink and different facets of organization performance or behaviour (Pfeffer and Salancik, 1978).

## **EMPIRICAL REVIEW**

Corporate governance broadly refers to the mechanisms, processes and relations by which corporations are controlled and directed. Governance structures and principles identify the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and include the rules and procedures for making decisions in corporate affairs.

Corporate governance includes the processes through which corporations' objectives are set and pursued in the context of the social, regulatory and market environment. Governance mechanisms include monitoring the actions, policies, practices, and decisions of corporations, their agents, and affected stakeholders. Corporate governance practices are affected by attempts to align the interests of stakeholders. Interest in the corporate governance practices of modern corporations, particularly in relation to accountability, increased following the high-profile collapses of a number of large corporations during 2001–2002, most of which involved accounting fraud; and then again after the recent financial crisis in 2008. Corporate scandals of various forms have maintained public and political interest in the regulation of corporate governance. In the U.S., these include Enron and MCI Inc. (formerly WorldCom). Their demise is associated with the U.S. federal government passing the Sarbanes-Oxley Act in 2002, intending to restore public confidence in corporate governance. Comparable failures in Australia (HIH, One.Tel) are associated with the eventual passage of the CLERP 9 reforms. Similar corporate failures in other countries stimulated increased regulatory interest (e.g., Parmalat in Italy).

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



performance (Sanda et al, 2005). It will help to promote a firm's performance and protect stake holder's interests.

## **RESEARCH METHODOLOGY**

### **Research Design**

According to Kothari (2004) research design is defined as framework that shows how problems under investigation will be solved. A descriptive survey is a design that involves establishing what is happening as far as a particular variable is concerned. This was a descriptive survey of all the commercial banks that are listed in Nairobi Securities Exchange. It is considered to be appropriate for this study since it allows the researcher to use both qualitative and quantitative data in trying to establish the effect of corporate governance on the financial performance of commercial banks listed at Nairobi Securities Exchange in Kenya.

### **Population of Study**

Target population is defined as a complete set of individuals, cases or object with some common observable characteristics of a particular nature distinct from other population. The definition ensures that the population of interest is homogeneous. According to Mugenda & Mugenda (2003), a population is a well-defined or set of people, services, elements, and events, group of things or households that are being investigated. This study is about the effect of corporate governance in selected commercial banks listed in Nairobi Securities Exchange that are operating in Kenya. The population of this study includes a census of the commercial banks in Kenya. According to the Capital Markets Authority, there are eleven commercial banks listed in Nairobi Securities Exchange in Kenya. The study focuses on the eleven banks listed in Nairobi Securities Exchange.

### **Data Collection Instruments**

The study uses primary data for purposes of analyzing the relationship between board structure and financial performance of commercial banks listed in Nairobi Securities Exchange. Primary data was obtained using questionnaires. Data collection involves self administered questionnaire.

### **Data Collection Procedures**

According to Cooper & Emory (2008), the questionnaire is conveniently used because it is cheaper and quicker to administer, it is above researcher's effect and variability, and is highly convenient for the respondents as they could fill them during free times or when workloads are manageable. The researcher dropped the questionnaire physically to the respondent's place of work. The researcher left the questionnaire with the respondent and collected them later. Each questionnaire was coded and only the researcher knew which person responded. The coding technique was only used for purposes of matching returns, completed questionnaires with those

delivered to the respondents. Reliability is increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing procedures.

### **Data Analysis**

Data collected was mostly quantitative, and it was analyzed by descriptive analysis techniques. The descriptive statistical tools such as SPSS helped the researcher to describe the data and determine the extent used. Content analysis was also used to analyze qualitative data. The findings were presented using tables and charts, percentages, means and other central tendencies. Tables were used to summarize responses for further analysis and facilitate comparison. For this study, the researcher was interested in establishing the relationship between corporate governance and financial performance of Commercial Banks listed in Nairobi Securities Exchange. This will generate quantitative reports through tabulations, percentages, and measures of central tendency. The following analytical model was used in analyzing the relationship between the dependent and independent variables:

$$F_p = a + b_1X_1 + b_2X_2 + e$$

Where:  $F_p$  is the financial performance of commercial banks listed in Nairobi Securities Exchange measured by return on asset (ROA), return on equity (ROE) and net interest margin (NIM);  $X_1$  is the board size;  $X_2$  is the ethnic composition of board members;  $e$  is the error

### **RESEARCH RESULTS**

Study findings reveal that board size had a positive correlation with the financial performance of listed commercial banks in NSE while Ethnic composition reported the same result of positive correlation with financial performance of listed commercial banks in NSE. However as financial performance is not an absolute, level of corporate governance will vary based on a variety of factors and the levels may change from year to year as the firm's operation environment changes. Corporate governance plays a major role in managing financial performance of our financial institutions. The study also found that other potential variables which are evidenced by other researchers in other study settings as significant factors affecting financial performance is the company's turnover and cost reductions.

Moreover, the study findings found out that implementation of proper corporate governance is an essential element in the financial performance of listed commercial banks in NSE as indicated by the regression model that revealed that board size and ethnic composition have a positive correlation with the financial performance (ROE, ROA, NIM). According to the regression equation established, taking all factors (board size, and ethnic composition), the financial performance of the commercial banks will be 0.896, 1.153, & 1.191.

Further analysis of the various variables under consideration and their respective coefficients indicate that, the effects of corporate governance on the financial performance of commercial

banks are very insignificant. The summary model's multiple correlation factor (R) is only 0.949 indicating a strong level of prediction of the independent variables. Similarly, the coefficient of determination of the model which is only 90.1% indicates that corporate governance variables used in the model can only explain 90.1% of the dependent variable which is financial performance. The remaining 9.9% can only be explained by other variables not under consideration in this model. This therefore means that it can conclusively be said that firm characteristics does have a significant effect on the financial performance of commercial banks in Kenya.

Corporate governance has positive relation with financial performance hence the introduction of various governance policies will improve the financial performance and performance efficiency. Many different claims by different authors explaining the impact of corporate governance on financial performance of firms listed at (NSE) have been explored and analyzed vis-à-vis the findings of the study. Competing explanations to the various arguments have also been shown. It was not, however possible to confirm the relationship between financial performance and some of the prepositions because of lack of relevant comparative data from other groupings of firms not listed at (NSE) Future work should attempt to explore the linkages between transparency, communication, and performance in more depth and by use of different techniques.

These findings concur with those of Kaguri (2013) and Kisengo and Kombo (2012) who studied the relationship between firm characteristics and financial performance of Life Insurance companies in Kenya and the effect of firm characteristics of Microfinance sector in Nakuru, Kenya respectively. Their findings indicate that there is a positive and strong Pearson correlation coefficients implying that a significant influence of firm characteristics on financial performance of Life Insurance Companies in Kenya and that firm characteristics have significant positive effect on performance of Micro finance institutions respectively. Also, the study findings are in line with Mothibi (2015) who analyzed the effect of Entrepreneurial and firm characteristics on performance of Small and Medium Enterprises in Pretoria. His findings were that entrepreneurial and firm characteristics have significant positive effect on the performance of SMEs in Pretoria.

However, the study findings tend to differ with Kiganane, Bwisa and Kihoro (2012) who sought to assess the influence of firm characteristics on the effect of Mobile phone services on firm performance, a case study of Thika town in Kenya. They found out that firm characteristics have no statistical significant influence on the effect of mobile phone services on firm performance.

## **CONCLUSION**

From the findings on the effects of board size on the financial performance of listed banks, the study established that various aspects of composition of the board affect the financial performance to a great extent. This was also noted with ethnic composition where the aspect affected financial performance to a great extent. The study thus concludes that size of the board, and ethnic composition positively influence the financial performance of commercial banks

listed to a great extent. Therefore, the study concludes that there is a significant effect of corporate governance on the listed commercial banks in NSE, Kenya.

## **RECOMMENDATIONS**

For banks to have sustainable growth and stability they should embrace best practices of corporate governance which will ensure that shareholders wealth is looked after in the best way possible, that adequate risk management measures are put in place and that standards are not only in writing but that they are practiced on a day to day basis. The findings provide shareholders with information that they have an important role to force banks' management to implement good corporate governance. In order to control the managers to implement good corporate governance, they should establish certain control mechanisms. The study informs government that it has to be concerned with good corporate governance practices in banks since they are unique from other sector. The central bank of Kenya has to encourage banks to implement corporate governance practices through enacting rules and regulations. Corporate governance practices will ensure that banks maintain the level of risk they can handle and give depositors sufficiently safe level of their savings and investments.

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