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

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE
MASTERS OF BUSINESS ADMINISTRATION DEGREE, SCHOOL OF
BUSINESS, KENYATTA UNIVERSITY.
DECLARATION

STUDENT’S APPROVAL

I declare that this project is my original work and has not been presented in any other University for examination.

Signed

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SUPERVISOR’S APPROVAL

This is to certify that this project has been submitted for consideration with my approval as the university supervisor.

Signed

Date 26/11/08

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CHAIRMAN’S APPROVAL

This is to certify that this project has been submitted for consideration with my approval as the Chairman of the Department.

Signed

Date 27/11/08

Mr. James Muturi
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DEDICATION

I dedicate this research to my family members, especially my father who supported me both financially and emotionally. He was my tower of strength and mentor, encouraging me to persevere when I did not have the faith in my abilities.

I would also wish to dedicate this project to my beloved mother who has a pillar and anchor of my strength. She provided the much needed support, encouragement and prayers. God bless them all.
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I give thanks to the almighty Father for guiding me throughout the research and giving me hope when things seemed impossible.

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ABSTRACT

It is in a bank that savers deposit money and it’s from a bank that an entrepreneur obtains funds to finance his projects that ultimately contributes towards a nation’s development. Banks therefore provides the safe haven for depositors and are the source for investment in productive sectors of the economy. To keep this conveyor belt of development alive there must be a high level of trust that will make depositors keep their money in the bank.

It is on the basis of high level of trust that depositor’s keep their money in the bank hoping to collect it at their convenience whenever need arises. The mobilization of savings is crucial in national economic activities since it is these savings that are invested to spur economic growth. A high savings rate is therefore vital to the growth of any economy as it provides vital resources for investment.

It is argued that, the major reasons for the collapse of most of the banking institutions in Kenya could be attributed to: Weak corporate governance practices, poor risk management strategies, lack of internal controls, weaknesses in regulatory and supervisory systems, insider lending and conflict of interest.

An analysis of these factors shows that honest arms length dealing, measured and temperate risk taking or in other words good corporate governance practices in the banking industry are for critical for successful performance in the industry.

In the financial system, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the financial system much depends on the underlying soundness of its individual components and the connections between them – such as the banks, the non financial institutions and the payment systems. In turn, their soundness largely depends on their capacity to identify, measure, monitor and control their risks.

Banks face a wide range of complex risks in their day-to-day business, including risks relating to credit, liquidity, exposure concentration, interest rates, exchange rates, settlement and internal operations. The nature of banks’ business – particularly the maturity mismatch between their assets and liabilities, their relatively high gearing and their reliance on creditor confidence –creates particular vulnerabilities. The consequences of mismanaging their risks can be severe indeed – not only for the individual bank, but also for the system as a whole. This reflects the fact that the failure of one bank can rapidly affect another through inter- institutional exposures and confidence effects. And any prolonged and significant disruption to the financial system can have potentially severe effects on the wider economy.

The study used diagnostic research design and also used both the primary and secondary methods of collecting data. A census study was done and hence the sample size of the study included all the 48 commercial banks in Kenya. Only 25 banks responded to the
questionnaire. Both quantitative and qualitative data were collected for this study. Descriptive data analysis techniques were used in form of frequency distribution tables and graphs.

The conclusion obtained from the study was that corporate governance practices affects the financial performance of the banks. Commercial banks operating in Kenya, like any other form of business organization, in today’s dynamic financial landscape should focus on proper governance practices and principles not only to boost and enhance their financial performances but as path to gaining a better public image, thus recognized by the society in which the bank operates as socially receptive commercial bank(s) which may augment the bank operations and survival.
LIST OF ABBREVIATIONS

1. BCCI: Bank of Credit and Commerce International.
2. OECD: Organization for Economic Co-operation and development.
3. BCBS: The Basel Committee on Banking Supervision.
4. CBK: The Central Bank of Kenya
5. CEO: Chief Executive Officer.
DEFINITION OF TERMS

Corporate Governance: Corporate governance is the system by which banks are directed and controlled in pursuit of their aims, and by which they relate to their sources of capital.

Financial Performance: A company’s ability to generate new resources, from day-to-day operations, over a given period of time. Performance is gauged by net income and cash from operations.

Risk Management: Risk management is the systematic process for identifying the risks the business faces; evaluating them according to the likelihood of their occurring and the damage that could ensue; deciding where to bear, avoid, control, or insure against them (or any combination of these four); allocating responsibility for dealing with them; ensuring that the process actually works; and reporting material problems as quickly as possible to the right level.

Liquidity: It is the means by which a bank ensures that it can always pay what it owes on time, which is vital to confidence in it and so to survival. This is usually achieved by some combination of a well diversified asset base, holding readily marketable liquid assets, managing the maturity profile of assets and liabilities, and borrowing –lending in the inter-bank market.

Financial Risk in a banking organization is possibility that the outcome of an action or event could bring up adverse impacts. Such outcomes could either result in a direct loss of earnings/capital or may result in imposition of constraints on bank’s ability to meet its business objectives.

Bank transparency: It refers to the quality and quantity of public information on a bank’s risk profile and to the timing of its disclosure, including the bank’s past and current decisions and actions as well as its plans for the future.
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CHAPTER ONE

INTRODUCTION

1.0 Background of the Study

In the immediate post-independence Kenya, the banking and financial industry was highly controlled. However, after 1982, the government relaxed the hitherto stringent rules in the issuance of licenses, especially licenses to operate non-bank financial institutions (NBFI). The low capital requirement of only Ksh. 5 million for a non-bank financial institution brought about the mushrooming of these institutions in the country. The relaxed regulatory and supervisory systems with which the banking and financial institutions operated at this time brought with it a poor governance and a poor management culture in the industry.

The eighties thus witnessed the collapse of a number of banking institutions. The first casualty was the Rural Urban Credit Finance Company Limited, which was placed in interim liquidation in 1984. The institution was eventually liquidated. After the first failure, the government made extensive changes in both the Banking Act and the Central Bank of Kenya Act so as to stem further instability in the industry. The changes saw the capital adequacy requirement increased to Ksh. 15 million for banks. Currently the requirement is 1 billion Ksh. Another major change was the creation of Deposit Protection Fund – an insurance scheme paid for by the contributions by member banks to meet liabilities of small depositors in the event of collapse. In practice an institution could have deposits that were 13.3 times its paid up capital but no more. To have more deposits required more paid up capital. The maximum deposits an institution could accept were then tied to paid up capital, the provision being that no financial institution could have deposits such that the paid up capital was less than 7.5 percent of the total deposits. To further protect the core capital from erosion by bad and doubtful advances, statutory reserve fund was established to be funded by banks’ declared profits. Of such profits, 12.5 percent were to be transferred to reserves to guard against future losses. Such reserves were to be invested in government securities. Banks with international presence are required to hold capital equal to 8 % of the risk-weighted assets according to basel I.
It is worth noting however, that despite the government’s effort to streamline the banking sector by introducing statutory regulatory measures of containment more banks, 33 to be precise, have been liquidated or put under receivership in the period that followed the introduction of these control mechanisms. During this period, more banks collapsed due to the weak internal controls and bad governance and management practices. The Continental Bank of Kenya Limited and Continental Credit Finance Limited collapsed in 1986, Capital Finance Limited collapsed in 1987, and in 1989 seven banks, which had collapsed, were merged in to the Consolidated Bank of Kenya limited. Thereafter, thirteen banks collapsed in 1993 and five banks collapsed between 1996 and 1999. In 1999 Trust Bank, the sixth largest bank in Kenya – in terms of deposits - collapsed due mainly to insider lending to directors and shareholders. In June 2001, Delphis Bank Limited, formerly the local operator of the BCCI, was placed under receivership. The most recent bank failure was witnessed in June 2006 when Charter House bank was placed under statutory management.

1.1 Statement of the Problem

The International financial landscape is changing rapidly; economies and financial systems are growing in dynamism and complexity to become very competitive. Financial arenas are becoming more open, new products and services are being invented and marketed and regulators everywhere are scrambling to assess the changes and master the turbulence. An international wave of mergers and acquisitions has swept the banking industry as boundaries between financial sectors and products have blurred dramatically. In this brave new world, one fact remains unchanged, the need for countries to have sound resilient banking systems and strong banks with good corporate governance practices (Crepsi et al, 2002).

Corporate governance is about promoting corporate fairness, transparency and accountability (Berth et al, 2001). Governance is a requisite for survival and a gauge of how predictable the system for doing business in any country is. In developing countries, the importance of governance is to strengthen the foundation of society and chip into the global economy.
To understand corporate governance and financial performance variables in relation to commercial banks the major Corporate Governance practices, that is, financial transparency, disclosure and risk management will be dissected. Financial performance especially relating to commercial banks will also be reviewed based on the performance dimensions comprising: Asset quality, earnings and liquidity.

1.2 Research Objectives

1.2.1 General objective

To determine how corporate governance practices affects the financial performance of commercial banks in Kenya.

1.2.2 Specific objectives

The study seeks to achieve the following:

1. To determine how risk management affects the financial performance of commercial banks in Kenya.
2. To find out how financial disclosure affects the financial performance of commercial banks in Kenya.
3. To analyze how both the internal and external controls in the banks affects their financial performance.

1.3 Research Questions

This study will attempt to answer the following pertinent questions:

1. Does good management of risk enhance the financial performance of a bank?
2. Does complete financial disclosure assist the performance of commercial banks in Kenya?
3. How do internal and external controls in the banks affects their financial performance?
1.4 Justification of the Study

A review by Matama (2006) shows that research on corporate governance applied to financial intermediaries – more so banks- is scarce. This is confirmed by Oman (2001); Goswami, (2001) and Arun and Turner (2002). All hold the consensus that although the subject of corporate governance in developing economies has received a lot of attention in literature the corporate governance of banks in developing economies has been almost ignored by researchers. This idea is shared by Caprio and Levine (2002). Macey and O’Hara (2001) share this opinion and add that even in developed economies literature on the corporate governance of banks is very recent.

This scarcity demands urgent intervention and justifies the relevance of this study so as to provide guidance in corporate governance. Financial intermediaries are in most cases subject to regulations that limit the efficacy of external control mechanisms, such as the market for corporate control or competition in the product market. Consequently, corporate governance issues have to be addressed in a broader manner. In order that this deficiency is addressed, this study will provide information that will help meet this need.

1.5 Scope of the study

There are 48 commercial banks in Kenya according to the Central bank of Kenya. This study targeted all the commercial banks that had their headquarters in Nairobi Town.
CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction to literature review

Banking in Kenya is governed by the laws enshrined in the Kenyan statutes - of interest are the Banking Act, Chapter 488 Laws of Kenya and the Central Bank Act, Chapter 492 laws of Kenya. Currently, the way in which companies are managed and controlled in Kenya is intensely being scrutinized consequently pushing the subject of corporate governance to the top of the agenda. The focus on corporate governance is particularly crucial in financial services and, most of all, in the banking sector since this sector has lately become highly exposed to public scrutiny and has learned, in a costly manner, the risk of attracting adverse publicity through failings in governance and stakeholder relationships – for example the case of the Euro Bank, Daima Bank, Trust Bank, Charter House Bank.

Corporate governance is a crucial issue for the management of banks which should be looked at from two dimensions, that is their funding and, often, ownership of other companies as these make them a significant stakeholder in their own right. A well known industry and market research organization has observed that governance in banks is a considerably more complex issue than in other sectors since banks will attempt to comply with the same codes of good governance as other companies but, in addition, factors like risk management, capital adequacy and funding, internal control and compliance all have an impact on their matrix of governance (African development bank corporate governance strategy, 2007).

Of particular interest to this study is corporate governance. Corporate governance has been looked at and defined variedly by different scholars and practitioners; however they all have pointed to the same end, hence giving more of a consensus in the definition. For example, the OECD has defined corporate governance as a system on the basis of which business companies are directed and managed. It is upon this system that specifications are given for the division of competencies and responsibilities between individual
included parties, such as the board of directors, the supervisory board, the management and majority and other shareholders and formulates rules and procedures for adopting decisions on corporate matters.

In another perspective, Arun and Turner (2002) contend that there exist narrow approaches to corporate governance which views the subject as the mechanism through which shareholders are assured that managers will act in their interests. However, Shleifer and Vishny (1997) and Oman (2001) observe that there is a broader approach which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment. There is a consensus, however that the broader view of corporate governance should be adopted in the case of banking institutions because of the peculiar contractual form of banking which demands that corporate governance mechanisms for banks should encapsulate depositors as well as shareholders (Macey and O’Hara (2001)). Arun and Turner (2002) join the consensus by arguing that the special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to restrain the behavior of bank management. They argue further that the unique nature of the banking firm, whether in the developed or developing world, requires that a broad view of corporate governance, which encapsulates both shareholders and depositors, be adopted for banks. They posit that, in particular, the nature of the banking firm is such that regulation is necessary to protect depositors as well as the overall financial system.

This study adopts the broader view and defines corporate governance (in the context of banking) as: The manner in which systems, procedures, processes and practices of a bank are managed so as to allow positive relationships and the exercise of power in the management of assets and resources with an aim of advancing shareholder value and shareholder satisfaction together with improved accountability, resource use and transparent administration.

The Basel Committee on banking Supervision (1999) states that from a banking industry perspective, corporate governance involves the manner in which the business and affairs
of individual institutions are governed by their Boards of Directors and senior management, affecting how banks:

i. Set corporate objectives (including generating economic returns to owners);

ii. Run the day-to-day operations of the business;

iii. Consider the interest of recognized stakeholders;

iv. Align corporate activities and behaviors with the expectation that banks will operate in safe and sound manner, and in compliance with applicable laws and regulations; and,

v. Protect the interests of depositors.

The Committee further enumerates basic components of good corporate governance to include:

a. The corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;

b. A well articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;

c. The clear assignment of responsibilities and decision making authorities, incorporating hierarchy of required approvals from individuals to the board of directors;

d. Establishment of mechanisms for the interaction and cooperation among the board of directors, senior management and auditors;

e. Strong internal control systems, including internal and external audit functions, risk management functions independent of business lines and other checks and balances;

f. Special monitoring of risk exposures where conflict of interests are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management or key decisions makers within the firm (e.g. traders);
g. The financial and managerial incentives to act in an appropriate manner, offered to senior management, business line management and employees in the form of compensation, promotion and other recognition;

h. Appropriate information flows internally and to the public.

Banking supervision cannot function if there does not exist what Hettes (2002) calls “correct corporate governance” since experience emphasizes the need for an appropriate level of responsibility, control and balance of competences in each bank. Hettes expounds further on this by observing that correct corporate governance simplifies the work of banking supervision and contributes towards cooperation between the management of a bank and the banking supervision authority.

Crespi et al (2002) contend that corporate governance of banks refers to the various methods by which bank owners attempt to induce managers to implement value-maximizing policies. They observe that these methods may be external to the firm, as the market for corporate control or the level of competition in the product and labor markets and that there are also internal mechanisms such as a disciplinary intervention by shareholders (what they refer to as proxy fights) or intervention from the board of directors.

Donald Brash the Governor of the Reserve Bank of New Zealand when addressing the Conference for Commonwealth Central Banks on Corporate Governance for the Banking Sector in London, June 2001 observed that:

“... Improving corporate governance is an important way to promote financial stability. The effectiveness of a bank’s internal governance arrangements has a very substantial effect on the ability of a bank to identify, monitor and control its risks. Although banking crises are caused by many factors, some of which are beyond the control of bank management, an analysis of these factors shows that honest arms length dealing, measured and temperate risk taking or in other words good corporate governance practices in the banking industry are critical for successful performance in the industry. And poor risk management is ultimately a failure of internal governance. Although
banking supervision and the regulation of banks’ risk positions can go some way towards countering the effects of poor governance, supervision by some external official agency is not a substitute for sound corporate governance practices. Ultimately, banking system risks are most likely to be reduced to acceptable levels by fostering sound risk management practices within individual banks. Instilling sound corporate governance practices within banks are a crucial element of achieving this.”

David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, observed in 2000 that: “Corporate governance is of course not just important for banks. It is something that needs to be addressed in relation to all companies ... I do however believe that sound corporate governance is particularly important for banks. The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed”.

2.1 Corporate Governance in Kenya’s Banking Sector.

Matama Rogers (2006) argue that commercial banks pose unique corporate governance problems for managers and regulators, as well as investors and depositors. They observe that the intellectual debate in corporate governance has focused on two different issues:

- Whether corporate governance should focus exclusively on protecting the interests of equity claimants in the corporation or whether corporate governance should instead expand its focus to deal with problems of other groups – stakeholders – or non-stakeholder constituencies.

- Whether corporate governance should concern itself exclusively with the challenge of protecting equity claimants and attempts to specify ways in which the corporation can better safeguard those interests.
In addition, they state that the dominant model of corporate governance in law and economics is that the corporation is a “complex set of explicit and implicit contracts” meaning one should view the corporation as nothing than a set of contractual arrangements among the various claimants to the products and earnings generated by the business. The group of claimants includes not only shareholders, but also creditors, employee-managers, the local communities in which the firm operates, suppliers and customers. They contend that in the case of banks, these claimants also include the regulators in their role as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants.

According to Central Bank of Kenya (2002), corporate governance in the banking sector largely relates to the responsibility conferred to and discharged by the various entities and persons responsible for and concerned with the prudent management of the financial sector.

The corporate governance stakeholders in the banking sector include the following: The board of directors, the management, the shareholders, Central Bank of Kenya, external auditors and Capital markets Authority.

The customers and the general public also play a critical role in fostering corporate governance in the financial sector. In the late 1980s and early 1990s, corporate governance issues were low priority in the Kenya’s banking sector. Directors were never vetted, shareholders could start banks almost at will, the role of the external auditors was not well defined, the prudential regulations were scanty and at some stage banks supervision was not playing a major role in ensuring prudence in the financial sector. The effect was imprudent lending practices, excessive investment in fixed assets, inadequate systems to measure, identify and control risks and bank failure. Subsequently, the Central Bank undertook several measures to enhance corporate governance in the sector. The measures include:

- Introduction of an effective legal and regulatory framework
- Development of prudential regulations,
• Increased interaction with other regulatory authorities, directors and external auditors,

• Amendment of the Banking Act – for example:
  i. Section 24 (5) gives the Central Bank ability to arrange trilateral meetings with an institution and its auditor.
  ii. Section 31 (3) allows sharing of information between institutions.
  iii. Section 11 requires that facilities to a director be approved by the full board of directors and further empowers the Central Bank to remove directors from office if their loans are non-performing.
  iv. The banking regulations empower the Minister of Finance and the Central Bank to levy penalties for non-compliance with corporate governance principles and other violations of the Banking Act.

• All prudential regulations were also reviewed in the year 2000 to ensure enhanced corporate governance in the Banking sector.

In January 2002, the Capital Markets Authority while responding to the growing importance of corporate governance issued a Gazette Notice spelling out the guidelines, adherence to which is mandatory to all public listed banks. The Central bank observesthat many of the requirements are already taken care of either in the Banking Act or in prudential regulations, but notes further that even though this may be the case, there are some other issues contained in the guideline that the banking sector is yet to adopt and these include;

• Disclosure of the ten major shareholders of the company,
• Requirement that no person should hold more than five directorship in any public listed companie(s) at any one time,
• Executive directors to have affixed service contact not exceeding five years with a provision for renewal,
• No person to hold more than two chairmanships in any public listed company at any one time, and;
• Inclusion of a statement on corporate governance in the annual accounts.
The Central Bank has also gone a step further to request all banks including those that are not public quoted to include a statement on corporate governance in their annual accounts. The Central Bank is also committed to encouraging all financial institutions and especially the private ones to adopt the Capital markets Authority guidelines and Commonwealth principles on corporate governance.

In October/November 2000, the Commonwealth corporate governance working group at a conference in Nairobi set out a check list of the policy issues that are relevant to assessing the effectiveness of corporate governance in the financial sector. As a follow up on this, the Central Bank of Kenya has implemented up to 70% of the principles. The remaining 30% include:

- Legal obligation that directors confirm the solvency of their institution before distribution of dividends,
- Disclosure of financial and risk related information by banks in respect of not only the bank but also consolidated group,
- Disclosure of the banks’ credit rating,
- Linking of deposit insurance to stringent requirements with respect to financial disclosure, corporate governance and risk management, and;
- Bank directors to undertake professional training and courses on corporate governance before appointment as director,
- Requirement that banks periodically change their auditors in order to enhance independence of auditors.

Another issue that touches on governance issues in banking includes risk management. The Central Bank of Kenya (2001), observes that the ever changing business environment characterized by globalization and deregulation has presented the banking sector with great challenges, which call for sound management systems capable of early identification, measuring, monitoring and controlling the various banking risks which include credit, currency, liquidity, interest rate and operational risks. The Bank observes that effective management of risks in banks requires risk management processes that
cover the following: Management oversight, Policies and procedures, Risk measurements and internal controls.

Several challenges to sound risk management in the banking sector in Kenya have been observed to include:

- Lack of appropriate systems that can monitor compliance with internal control policies and limits on timely basis.
- Risk control functions and business operations are not well segregated, leading to conflict of interest in risk management.
- The presence of Board members, who do not possess sufficient skills and knowledge to understand banking risks, renders the Board less effective in risk management.
- Limited source of good information on credit.
- Customers who at times give dishonest and inaccurate financial information.

2.2 Bank Financial Performance.

Fries et al (2002) while examining the same phenomenon found out that bank performance differs significantly depending on the reform environment as well as the competitive conditions in which they operate.

In the Kenyan context, the following indicators can therefore measure the performance of a bank:

a. Capital adequacy – this is measured in terms of total capital to total risk weighted asset ratio, which shows the amount of capital an institutions holds relative to the risk profile of its assets. It provides the cushion to protect depositors and creditors in case of loss. In the Kenyan situation, institutions are required to maintain a minimum ratio of 12% capital adequacy. Additionally, banks are expected to satisfy the following capital requirements:
• Minimum core capital (capital after adjustment for losses and excludes revaluation reserves and goodwill) of Ksh. 300 million for banks and Ksh. 225 for non-bank financial institutions,
• Minimum ratio of the core capital to deposits of 8%,
• Minimum ratio of core capital to total risk assets ratio of 8%.

b. **Asset quality** – this is rated on the basis of the proportion of non-performing loans net of provisions to gross loans. It involves loans and advances, which are categorized into five groups depending on the time, past due: Normal risk, Watch, Substandard, Doubtful, and Loss.

c. **Earnings and liquidity** – earnings are measured on the basis of return on assets while liquidity of the banking system is measured by the ratio of the net liquid assets to total deposits.

Other parameters may also include: Market share, Lending behavior, Distribution of bank profitability, Credit distribution, Composition and changes in assets, Liabilities, Deposits, Capital and reserve, Profit and loss.

### 2.3 The Elements of Corporate Governance.

Different authors and management specialists have argued that corporate governance requires laid down procedures, processes, systems and codes of regulation and ethics that ensures its implementation in organizations. Some suggestions that have been underscored in this respect include the need for banks to set strategies – which have been commonly referred to as corporate strategies - for their operations and establish accountability for executing these strategies. El-Kharouf (2000) while examining strategy, corporate governance and the future of the Arab banking industry, points out that corporate strategy is a deliberate search for a plan of action that will develop the corporate competitive advantage and compound it.

In addition to this, the BCBS (1999) contends that transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a
bank. The Committee advances further that various corporate governance structures exist in different countries hence there are no universally correct answer to structural issues and that laws do not need to be consistent from one country to another. Sound governance therefore, can be practiced regardless of the form used by a banking organization. The Committee therefore suggests four important forms of oversight that should be included in the organizational structure of any bank in order to ensure the appropriate checks and balances. These include:

1. Oversight by the board of directors or supervisory board;
2. Oversight by individuals not involved in the day-to-day running of the various business areas;
3. Direct line supervision of different business areas, and;
4. Independent risk management and audit functions.

In summary, they demonstrate the importance of key personnel being fit and proper for their jobs and the potentiality of government ownership of a bank to alter the strategies and objectives of the bank as well as the internal structure of governance hence the general principles of sound corporate governance are also beneficial to government-owned banks.

The concept of good governance in banking industry empirically implies total quality management, which includes six performance areas (Warner et al 1988). These performance areas include capital adequacy, assets quality, management, earnings, liquidity, and sensitivity risk. Warner argues that the degree of adherence to these parameters determines the quality rating of an organization.

According to Frank et al (2001), corporate governance mechanisms including accounting and auditing standards are designed to monitor managers and improve corporate transparency.
2.4 Summary and Gaps to be filled by the study.

In any single economy, banks play an important and sensitive role. Their performance directly affects the growth, efficiency and the stability of the economy. Therefore, corporate governance is of special importance and hence, considered the key for the corporate to successfully achieve its strategy and ensure the stable development of the sector.

In the banking sector, international integration has brought opportunity to international exchange and co-operation, allowing Kenyan banks to have access to global funding sources and technical assistances, therefore permitting them to better meet capital need (in particular long term capital) of the economy and serving as a stimulus for reform and modernization of Kenyan banking sector and for the enhancement of banking management capability in accordance with international standards.

Strictly following corporate governance principles and enhancing banking governance efficiency is always banking sector’s utmost concern and considered the prerequisite for the sector’s stability and growth. In general, this has a positive correlation with stable development of enterprises. This also has positive impact on the economy as a whole. In particular, good corporate governance in Kenyan banks will bring a sound financial situation to banking sector; create chance for capital accumulation to reinvest more efficiently into the economy (Centre of corporate governance, 2004).

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.
2.5 Conceptual Framework

From figure 1, the independent variables include risk management, bank transparency, financial disclosure and regulatory framework while the dependent variable is financial performance. Financial performance as the dependent variable is influenced by the independent variables which can determine the financial performance in terms of asset quality, earnings and liquidity. The presence of intervening variables which include expectations of internal and external stakeholders adversely affect financial performance. The above variables were measured using ordinal scale whereby the sum total of each bank responses to questionnaire items were analyzed in order to answer research questions of the study.
CHAPTER THREE
RESEARCH METHODOLOGY

3.0 Introduction

This chapter endeavored to illustrate data collection procedures and analysis methods utilized in the study. It includes: research design, target population, data collection procedures and analysis. It gives a step by step account of how the above activities were carried out in order to address the purpose of the study which was to analyze the effect of corporate governance practices on the financial performance of commercial banks in Kenya.

3.1 Research Design.

A research design is the arrangement of conditions for collection and analysis of data that aims to combine relevance to the research purpose with economy in the procedure. The research design used was diagnostic as the paper intended to analyze the effect of corporate governance practices on the financial performance of commercial banks in Kenya. Also taking cognizance of the fact that educational research contains many variables that cannot realistically be controlled, then diagnostic research design was the most appropriate approach. Indeed, Sridhar (2008) in a paper titled ‘Research design and plan’ describes diagnostic research design as efficient, economical, has maximum reliability, minimum biases and smallest error.

The research design consisted of four components which included comparison, manipulation, control and generalization. Comparison was used to show that there is relationship between variables. The study determined the extent to which the variable corporate governance practices influenced financial performance and therefore the existing relationship. Further the interrelationships of various variables measured using the questionnaire was explored. The final results were deemed to apply to the whole population through generalization.
3.2 Target Population.

The population of the study consisted of all the 48 commercial banks in Kenya. The study was a census hence the whole population was included. A census was deemed appropriate since the target population was small hence manageable. The respondents were finance directors in the finance departments of the banks’ headquarters.

The respondents (finance directors) were selected based on their knowledge about and involvement in the banks. Due to the position they occupy and their extensive knowledge and experience in the bank, the information generated was considered to be representative of the views of the bank, which the respondents represented and was therefore regarded as sufficient to provide a holistic picture of the problem under investigation.

3.3 Data Collection Procedures.

Data was collected using questionnaires which were personally administered by the researcher. The questionnaires were semi-structured and based on open-ended and closed questions of both substantive and theoretical nature. The purpose of the substantive questions was to measure the various variables and the purpose of the theoretical questions was to link the features of risk management, bank transparency and disclosure, regulatory framework and financial performance in the context of the banks to findings in previous studies.

Questionnaires were considered to be the best for gathering the required data given the budgetary constraints under which the research was carried out. Indeed, Hakim (2000) in her book “Research Design: Successful design for social science and economic research” she describes questionnaires as one of the cheaper and efficient method that a researcher can use when trading to a cheaper research design in cross sectional studies. Thus given
the time and resources constraints under which the research was undertaken, questionnaires were the best method of data collection.

Secondary data was obtained from existing literature i.e. published annual reports; CBK supervision reports books, articles, journals and other relevant publications. The information obtained was earlier research findings, conclusions and the limitations.

3.4 Data Analysis.

Completed questionnaires were reviewed and edited for completeness, coded, labeled and keyed into the computer for statistical analysis using Statistical Package for Social Scientists (SPSS). SPSS was used to process data in order to determine the relationship between variables. Descriptive data analysis techniques were used in form of frequency distribution tables to show the various findings. This technique was chosen because it was possible to show the distribution or the count of individual scores in the population for a specific variable. Columns on frequency gave an absolute count of the occurrence while the columns on percentages gave the proportion of a subgroup of the total population. This in turn ensured easy, accurate comparison and conclusions.

SPSS was also used to process data in order to determine the relationship between variables. Specifically chi square was used to determine if there is a relationship between bank performance, risk management, regulatory framework and bank transparency and disclosure.
CHAPTER FOUR

PRESENTATION INTERPRETATION AND DISCUSSION OF THE FINDINGS

4.0 Introduction

This chapter describes the analysis of data and presents research findings. The results are presented in the form of frequency distribution and graphs. The response rate was at 52.1% as out of the 48 banks which were surveyed, 25 responded as illustrated below in table 1.

Table 1 Number of banks surveyed

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responded</td>
<td>25</td>
<td>52.1</td>
</tr>
<tr>
<td>Didn’t respond</td>
<td>23</td>
<td>47.9</td>
</tr>
<tr>
<td>Total</td>
<td>48</td>
<td>100%</td>
</tr>
</tbody>
</table>

4.1 Data Analysis and interpretation of results

In the pursuit of good corporate governance in Kenya, the Capital Markets Authority in exercise of the powers conferred to it by sections 11(3) (v) and 12 of the Capital Markets Act Chapter 485A Laws of Kenya, issued guidelines (Kenya Gazette notice number 3362) to be observed by public listed companies in Kenya, in order to enhance corporate governance practices by such companies. It is upon these guidelines that banks have set up corporate governance procedures.

The banks surveyed have been in Kenya for a period ranging from 1.5 months to 97 years. Of the banks, 18 were privately owned while 7 were government owned.
Management and the Board

The number of Board members ranged from 5 to 16. Boards should be no larger than strictly necessary for the conduct of business, even when they include appointees from large shareholders. The larger boards get, the more likely it will be in practice for serious decisions to be decided by an inner committee beforehand. It is recommended that the Board comprises between seven and eleven members.

The powers of the Board that were mentioned by all the banks included: Policy making and decisions, Regulation of issuance and management of shares, Performance reviews, Compliance audits and corporate governance.

According to the Capital Market Authority corporate governance regulations, the board of directors is expected to assume a primary responsibility of fostering the long-term business of the banks consistent with their fiduciary responsibility to the shareholders.

Responsibilities of the Board

The responsibilities of the board mentioned by all the banks included: Policy formulation in accordance with the relevant Acts, Provision of leadership, Formulate strategies, Receive and approve reports of committees, Approve key financial objectives, budgets and business reports, Good corporate governance, Approval of loans, Approval of expenditures, Ensuring compliance to Statutory and regulatory frameworks, Banking projections and Safeguarding the assets of the bank.

All the banks under the study reported that the responsibilities of the Board are clear to both the Directors and the management.

On analysis, the frequency table and graph below were generated and subsequent observations made.
Table 2 Board members appointments

<table>
<thead>
<tr>
<th>Type of election</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>By the vote of majority shareholders</td>
<td>6</td>
<td>24</td>
</tr>
<tr>
<td>By the vote of all shareholders</td>
<td>14</td>
<td>56</td>
</tr>
<tr>
<td>By the old board when a new one is coming into office</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Other process</td>
<td>4</td>
<td>16</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>25</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Figure 2

It is expected that a formal and transparent procedure in the appointment of directors to the board and all persons offering themselves for appointment, as directors should disclose any potential area of conflict that may undermine their position or service as director.

From the frequency table 2 and figure 2 above, most of the board members are appointed by the vote of all shareholders (56%), by the vote of majority shareholders (24%), other processes (16%) and by the old board when a new one is coming into office (4%).

The other processes included; the chairman is appointed by the government through treasury and others appointed to represent shareholders. The conclusion then is that the Board is able to serve the legitimate interests of all members and account to them fully.
Regarding the Board’s effectiveness in terms of leadership, integrity, enterprise, judgement and decision making, majority rated their Boards to be very effective as shown in table 3 and figure 3.

Table 3 Board members’ effectiveness.

<table>
<thead>
<tr>
<th></th>
<th>Very effective</th>
<th>Not very effective</th>
<th>Effective</th>
<th>Below average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leadership</td>
<td>14</td>
<td>3</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>Integrity</td>
<td>20</td>
<td>5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Enterprise</td>
<td>12</td>
<td>8</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Judgment</td>
<td>15</td>
<td>0</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Decision making</td>
<td>22</td>
<td>3</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Figure 3

Every bank should be headed by an effective board to offer strategic guidance, lead and control the company and be accountable to its shareholders. The study has established that in terms of leadership, integrity, enterprise, judgement and decision making, majority of the Boards in the study were reported to be effective. From table 3 and figure 3, the board members’ effectiveness was lead by decision making, integrity, judgement, leadership and enterprise in that order. The deduction then is that Board members are
able to direct the Bank so as to achieve continuing prosperity and to act in the best interest of the Bank in a manner based on transparency, accountability and responsibility.

On analysis the frequency of the board meetings is shown below as represented by the table and the graph.

**Table 4 The frequency of board meetings**

<table>
<thead>
<tr>
<th>Board meetings</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Semi-annually</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>Annually</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Others</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>25</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

**Figure 4**

From table 4 and figure 4 the frequency of board meetings is through quarterly meetings, which is at 80%. This is usually for the full board. The inference then is that the board members are able to deliberate on matters as quickly as they occur and hence being able to solve the problems faster.

On analysis the banks’ succession plan for the senior management is represented as shown below in the table and graph.
Table 5 The bank succession plan for the senior management

<table>
<thead>
<tr>
<th>The succession plan</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>19</td>
<td>76</td>
</tr>
<tr>
<td>No</td>
<td>6</td>
<td>24</td>
</tr>
<tr>
<td>Total</td>
<td>25</td>
<td>100%</td>
</tr>
</tbody>
</table>

Figure 5

From table 5 and figure 5, 76% of the banks have a succession plan for senior management while 24% of the banks do not have a succession plan.

The succession plans for the senior management do exist in varied scenarios in different banks. Some of the succession plans recorded include, external and internal training for management, an arrangement where every head of a department has a deputy, existing executive under the CEO. The supposition is that there is a clear plan that banks execute in appointing the senior management so as to achieve corporate objectives, prosperity and sustainability.
Shareholders and Stakeholders

It is expected that there should be shareholders’ participation in major decisions of the Company. The board should provide the shareholders with information on matters that include but are not limited to major disposal of the Company’s assets, restructuring, takeovers, mergers, acquisitions or reorganization.

The approximate total number of shareholders in the banks surveyed ranged between 10 and 26. Shareholders are able to exercise the authority to ensure that only competent and reliable persons are elected or appointed to the board of directors. They have the power to ensure that the board is held accountable for the effective running of the bank, so as to achieve its objectives and change the composition of the board that does not perform to expectations or in accordance with the mandate of the bank. In terms of accountability to shareholders, there exist board committees (in most cases the audit committee) to ensure this.

There are several ways through which the Board’s deliberations are communicated to shareholders and stakeholders which include, Circulation of minutes, at the Annual General Meetings, Quarterly publications, news briefings on press and on joint ventures.

The external stakeholders included, the central bank, capital markets authority, customers, labour stakeholders (Federation of Kenya employees, C.O.T.U), suppliers, government, community and business associates.

10 banks indicated the policies that guide how the banks should relate with the external stakeholders. They included, the Banking Act, the Central bank of Kenya Act, the Companies Act, Capital Markets Authority Act, Finance Act, Central Depository System Act, Capital Market Regulations (Corporate Governance Guidelines, Securities, Public offers and disclosures, Collective Investment Scheme, Takeovers and Mergers, Rating Agency Approval Guidelines) and Income Tax Act.

The conclusion then is that the board should identify the Bank’s internal and external stakeholders; agree on a policy or policies determining how the Bank should relate to,
and with them, in creating wealth, jobs and the sustainability of a financially sound Bank while ensuring that the rights of stakeholders [whether established by law or custom] are respected, recognized and protected.

**Strategy, Values, Performance and Compliance**

On analysis, the frequency table and graph below were generated and subsequent observations made.

**Table 6 Performance of the board of directors**

<table>
<thead>
<tr>
<th></th>
<th>In all cases</th>
<th>Some times</th>
<th>Not at all</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose and values of the bank</td>
<td>20</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Strategy to achieve the bank’s purpose</td>
<td>10</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>Implementation of the banks values</td>
<td>6</td>
<td>19</td>
<td>0</td>
</tr>
</tbody>
</table>

![Bar graph](image_url)

**Figure 6**

From table 6 and graph 6 the board members determine the purpose and values of the bank in all cases while sometimes they determine the strategy to achieve the bank’s purpose and implementation of the bank’s values.

The deduction then is that the board members should determine the purpose and values of the Bank, determine the strategy to achieve that purpose and implement its values in
order to ensure that the Bank survives and thrives and that procedures and values that protect the assets and reputation of the Bank are put in place.

On analysis, the frequency table and graph below were generated and subsequent observations made.

Table 7 Resignation of the board members citing disagreements in banks

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>25</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>25</td>
<td>100%</td>
</tr>
</tbody>
</table>

Figure 7

From table 7 and figure 7 above, all the banks indicated that no board member has resigned citing disagreements with the strategy, values and compliance of the bank.

The deduction then is that the board of directors is full involved with all the activities of the bank and deliberates on issues regarding strategy, values and compliance of the bank. All the same this might not be true because no bank would want to portray a negative image of their board members so as to maintain a good picture to the public.

On analysis, the frequency table and graph below were generated and subsequent observations made.
Table 8: Bank compliance with relevant laws, regulations and governance practices

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>0</td>
<td>25</td>
</tr>
<tr>
<td>100%</td>
<td>0</td>
<td>100%</td>
</tr>
</tbody>
</table>

Figure 8
From table 8 and figure 8 above, all the banks have measures (100%) in place to ensure that the bank complies with all the relevant laws, regulations and governance practices, accounting and auditing standards.

The regulatory and supervision systems have been issued by the Central Bank of Kenya and International Acceptable Accounting Standards. Some banks have also developed own in-house systems to ensure this.

These systems have effectively promoted a sound and stable market based banking system in Kenya by:

- Fostering liquidity and solvency of banking institutions,
- Ensuring efficiency in banking operations, and:
- Encouraging high standards of customer service.

This has been achieved through the enforcement of the Banking Act and the prudential regulations by the Central Bank of Kenya.

On analysis, the frequency table and graph below were generated and subsequent observations made.
Table 9 who enforce these measures?

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board</td>
<td>10</td>
</tr>
<tr>
<td>Chief executive</td>
<td>17</td>
</tr>
<tr>
<td>Shareholders</td>
<td>4</td>
</tr>
<tr>
<td>All departmental heads</td>
<td>12</td>
</tr>
<tr>
<td>Any body in the managerial position</td>
<td>7</td>
</tr>
</tbody>
</table>

From table 9 and figure 9 above, it shows that in most banks the chief executives and board members enforce the measures in place to ensure that the bank complies with all relevant laws, regulations and governance practices, accounting and auditing standards. The conclusion is that the board members and chief executives are able to ensure that the bank complies with all relevant laws, regulations, governance practices, accounting and auditing standards.

Risk Management

Risk management is a cornerstone of prudent banking practice. The purpose of financial institutions is to maximize revenues and offer the most value to shareholders by offering a variety of financial services, and especially by administering risks.

Oldfield and Santomero (1997) refer to three generic risk-mitigation strategies:

1. Eliminate or avoid risks by simple business practices;
2. Transfer risks to other participants; and
3. Actively manage risks at the bank level (acceptance of risk).

On analysis, the frequency table and graph below were generated and subsequent observations made.

**Table 10 Risk avoidance practices used**

<table>
<thead>
<tr>
<th>Risk avoidance practices</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standardization of process, contracts and procedures</td>
<td>20</td>
</tr>
<tr>
<td>Construction of portfolios</td>
<td>15</td>
</tr>
<tr>
<td>Implementation of incentive-compatible contracts</td>
<td>6</td>
</tr>
<tr>
<td>All the above</td>
<td>9</td>
</tr>
</tbody>
</table>

**Figure 10**

Risk management practices might be considered the most important aspect of risk management.

From table 10 and figure 10 above, the risk avoidance practice mostly used is the standardization of process, Contracts and procedures, followed by construction of portfolios and then implementation of incentive-compatible contracts. Other banks indicated that they used all the three methods. Other practices used includes: having an audit committee to help identify the risky areas and Asset-liability committee.

In conclusion, appointing an audit committee is sound practice, and many banks consider it indispensable. Most regulators require banks to do so. The key features of a good audit committee are its thoroughness and its independence. Also the asset liability committee ensures that risk management is not confined to collection of data. Rather, it ensures that detailed analysis of assets and liabilities is carried out so as to assess the overall balance sheet structure and risk profile of the bank.
On analysis, the frequency table and graph below were generated and subsequent observations made.

**Table 11 Techniques employed to manage the different types of risks**

<table>
<thead>
<tr>
<th>Techniques to manage the risks</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard and reports</td>
<td>21</td>
</tr>
<tr>
<td>Position limits and rules</td>
<td>16</td>
</tr>
<tr>
<td>Investment guidelines or strategies</td>
<td>11</td>
</tr>
<tr>
<td>Incentive contracts and compensation</td>
<td>7</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
</tr>
</tbody>
</table>

**Figure 11**

The risk management techniques are employed to both limit and manage the different types and also encourage decision makers to manage risk in a manner that is consistent with the firm’s goals and objectives.

From table 11 and figure 11 above, the technique mostly used is standard and reports, followed by position limits and rules, then investment guidelines or strategies and finally incentive contracts and compensation. Other banks indicated that they used all the above techniques.

In conclusion, the standard and report technique is consistent in evaluation and rating of exposures of various types of risks and also it is essential in understanding the risks in the portfolio, and the extent to which these risks must be mitigated or absorbed.
The techniques are implemented as below,

- The reports should report on specified areas and format.
- Position limits and rules are predetermined
- Investment guidelines or strategies are issued to departmental heads.
- Incentive contracts and compensation through service level agreements.
- Through training.

Bank Performance

As noted earlier, financial performance was considered the dependent variable in this project, before correlating it with governance variables its magnitude within the commercial banks was ascertained. Secondary data especially from respective commercial banks annual-reports (from 2005 to 2007) were used to extract the summary of the banks financial performance based on, Asset Quality, Earnings and Liquidity as recommended by CBK for measuring Financial Performance (CBK 2002).

Asset Quality, which was measured by NPA/ Total advances and Specific Provisions, indicated that most banks were above the FIS (2007) requirement of 25%. Earning assets is any income- earnings assets owned by a company. Earnings, which are measured by Return on assets, return on equity and overheads to earnings ratios, indicated that some banks earnings performance was below zero. Some other banks indicated a steady movement upwards especially on their Return on assets ratios.

From the questionnaire where the respondents were asked to comment briefly on certain issues regarding the financial performance of the banks, the earnings and liquidity of most banks were above the minimum requirements of 20% although others indicated that it was below average. Liquidity which is measured by Liquid Assets/Total Deposits and Total Advances/Total Deposits ratios, indicated that in the overall commercial banks were highly liquid over the trend 2005 to 2007.
About the lending behaviours some banks indicated that they were conservative and others had secured loans. On distribution of banks profitability in most banks the majority were based on interest income especially the privately owned while for government owned on government investments.
CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.0 Introduction

As stated in section 1.1 of this paper, the purpose was to determine how corporate governance practices affect the financial performance of commercial banks in Kenya. Bank’s governance is critical not only because of its benefits to shareholders and depositors, but also because effectively governed banks are more efficient and prudent in directing their resources. After data analysis, the findings of the study are outlined below.

5.1 Summary of the Findings

There are 48 banks in Kenya. The banks have been in Kenya for a period ranging from 1.5 months to 97 years. The number of Board members range between 5 and 16. The average board members for all the banks are 11. Most of the board members are appointed by the vote of all shareholders (56%), by the vote of majority shareholders (24%), other processes (16%) and by the old board when a new one is coming into office (4%). The other processes included; the chairman is appointed by the government through treasury and others appointed to represent shareholders.

The powers of the Board that were mentioned include, policy making and decisions, regulation of issuance and management of shares, performance reviews, compliance audits and corporate governance. Responsibilities of the Board include policy formulation in accordance with the relevant Acts, keeping proper books of accounts, preparation of financial statements, provision of leadership, formulation of strategies, receiving and approving reports of committees, approval of key financial objectives, budgets and business reports, good corporate governance, approval of loans and expenditures, ensuring compliance to statutory and regulatory frameworks, banking projections and safeguarding the assets of the bank. In all the banks under the study, the responsibilities of the Board are clear to both the Directors and the management.
Regarding the Board’s effectiveness in terms of leadership, integrity, enterprise, judgment and decision making, it was found out that majority of the Boards were effective. Most Boards have 4 meetings in a year. The Board’s deliberations are communicated to shareholders and stakeholders through circulation of minutes, at the Annual General Meetings, quarterly publications and press announcements.

The succession plans for the senior management do exist in varied scenarios in different banks. Some of the succession plans recorded include, external and internal training for management, an arrangement where every head of a department has a deputy, existing executive under the CEO.

In terms of accountability to shareholders, there exist board committees (in most cases the audit committee) to ensure this. Audit committees play a key role in financial control and reporting, thus strengthening corporate governance and increasing public confidence. In helping to protect the Bank’s assets, they are serving the interests of shareholders, investors, depositors, regulators, and all who work in and have dealings with the Bank.

All the banks reported that they have measures in place to ensure that the banks comply with all relevant laws, regulations, governance practices, accounting and auditing standards.

All the banks operate under the following legal framework, the Banking Act, the Central Bank of Kenya Act, the Companies Act, Capital Markets Authority Act, Finance Act, Central Depository System Act, Capital Market Regulations (Corporate Governance Guidelines, Securities, Public offers and disclosures, Collective Investment Scheme, Takeovers and Mergers, Rating Agency Approval Guidelines) and Income Tax Act. The State Corporations Act only applies in the case of State owned banks. All the banks have regulatory and supervisory systems under which they operate.
5.2 Conclusion

Commercial banks need to adopt and strengthen the corporate governance practices. After the commercial banks have established mechanisms to enforce proper governance practices such as financial disclosure, transparency and risk management. They will automatically build a bond of trust with their numerous stakeholders including customers, society, and government among others. Some of these stakeholders especially customers will in turn invest their funds in these banks. For instance, they buy shares when the respective commercial bank is listed both on the local capital market like Nairobi Stock Exchange (NSE) or on international Capital Markets like The New York Stock Exchange (NYSE) or any other capital market.

Commercial banks operating in Kenya, like any form of business organisation, in today's dynamic financial landscape should focus on proper governance practices and principles not only to boost and enhance their financial performances but as path to gaining a better public image, thus recognised by the society in which the bank operates as socially receptive commercial bank(s) which may augment the bank operations and survival.

5.3 Recommendations

The study has found out that:

(1) The corporate governance procedures applied in the banking sector in Kenya have been effective to some extent in achieving the goals and objectives upon which they were set, but it is still in its infancy.

- It is therefore recommended that strategic training for board members and senior bank managers be intensified by stakeholders in corporate governance to promote good corporate governance in these institutions. They should be guided to understand that “to remain competitive in a changing world, banks must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new
opportunities and the government has an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and to respond to expectations of shareholders and other stakeholders” — OECD.

- Banks should be assisted to develop principles of corporate governance that cut across all the functions of the banks.

(2) The strengths of the existing legal framework overweigh the weaknesses, however the following recommendations are provided:

- Expedient solution to the stalemate on the Central Bank of Kenya (Amendment) Act 2000 which was declared retrospective and inconsistent with the Constitution of Kenya. Following this ruling, various conflicting legal interpretations have been published which most banks find confusing.
- Issues of delays in decision making due to the existing legal framework should be addressed.
- Duplication of supervisory and regulatory procedures arising from the same should also be addressed.

(3) There is need for stakeholders to play an effective role in assisting the banks with necessary professional and technical assistance towards the implementation of corporate governance.

(4) The regulatory and supervision systems have been issued by the Central Bank of Kenya. Some banks have also developed own in-house systems to ensure this. More in-house systems are further recommended so that those systems that have been introduced through statutes can be supplemented by the in-house systems and enforcement.
REFERENCE.


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APPENDICES

APPENDIX 1

QUESTIONNAIRE

This questionnaire will assist in gathering information about the practices of corporate governance in commercial banks in Kenya. All the information gathered will be treated with highest confidentiality and it will be appreciated.

Please tick (✓) where applicable.

Date: ____________________________

Name of Bank: ____________________________

A: Introduction

1. For how long have this bank been in operation in Kenya? [______ Years]

2. List the percentage of the 10 largest shareholders in your bank.

   a) ____________________________
   b) ____________________________
   c) ____________________________
   d) ____________________________
   e) ____________________________
   f) ____________________________
   g) ____________________________
   h) ____________________________
   i) ____________________________
   j) ____________________________
3. If any of the shareholders are the government, please indicate the percentage of shareholding?

a) 

b) 

**B: Management and the Board**

4. What is the total number of the Board of Directors? [_____]

5. How is the board appointed?

   [1] By the vote of majority shareholders.  
   [2] By the vote of all shareholders.  
   [3] By the old board when a new one is coming into office.  

6. Please list the other processes from question 5 above.

   i. 
   ii. 
   iii. 

7. How effective do you consider the Board to be, in exercising the following so as to achieve the bank's objectives? Using the following terms


<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Leadership</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>2. Integrity</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

45
8. How frequently does the Board meet?

a. Semi-annually

b. Annually

c. Others

9. Does the bank have a succession plan for the senior management?

[1] Yes □

[2] No □

10. If yes, explain how it works?

_________________________________________________________________________________________________________________________________________________

C: Shareholders and stakeholders

11. What is the approximate total number of shareholders? [ ]

12. How does the bank communicate with its shareholders and stakeholders?

_________________________________________________________________________________________________________________________________________________
13. Who are the external stakeholders of the bank? Please list them.

   a) 
   b) 
   c) 
   d) 
   e) 

14. Please indicate the policies which guide how the bank should relate with the external stakeholders?

   a) 
   b) 
   c) 
   d) 
   e) 

D: Strategy, values, performance and compliance

15. Would you say the Board of Directors does determine the following?


<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
</table>
   i. The purpose and values of the bank | | | |
   ii. The strategy to achieve the bank’s purpose | | | |
   iii. Implementation of the banks values | | | |

16. Has any Board member resigned citing disagreements with the strategy, values and compliance of the bank?
17. Is there any measure in place to ensure that the bank complies with all relevant laws, regulations, and governance practices, accounting and auditing standards?

[1] Yes  ☐

[2] No   ☐

18. Please state the measures?

19. Who enforces these measures?


[2] The chief executive  ☐

[3] The shareholders  ☐

[4] All departmental heads  ☐


E: Risk Management

20. Which risk avoidance practices do you use?

a. Standardization of process, contracts and procedures  ()

b. Construction of portfolios  ()

c. Implementation of incentive-compatible contracts  ()

d. All the above  ()

e. Others
21. What techniques are employed to both limit and manage the different types of risks?

1. Standard and reports
2. Position limits and rules
3. Investment guidelines or strategies
4. Incentive contracts and compensation
5. Others

22. How are the above techniques implemented in each area of risk control?

F: Bank performance

23. Could you please provide the figures for the following indicated financial years?

<table>
<thead>
<tr>
<th>Years</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yield on earning assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of funding earning assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest margin on earning assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yield on Advances</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on assets (including contingents)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on shareholders funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overheads to earnings</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
24. Briefly comment on the status of the banks on the following:

1. Capital adequacy.

2. Earnings and liquidity.

3. Market share.

4. Lending behavior.

5. Distribution of bank profitability.

6. Credit distribution.

7. Composition and changes in assets.
8. Liabilities.


9. Capital and reserve.


## APPENDIX 2

### WORK PLAN

<table>
<thead>
<tr>
<th>ACTIVITIES</th>
<th>TIME</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposal writing</td>
<td>Five weeks</td>
</tr>
<tr>
<td>Proposal correction</td>
<td>One week</td>
</tr>
<tr>
<td>Defense of proposal</td>
<td>One day</td>
</tr>
<tr>
<td>Pilot study</td>
<td>One week</td>
</tr>
<tr>
<td>Data collection</td>
<td>Four weeks</td>
</tr>
<tr>
<td>Data analysis</td>
<td>Four weeks</td>
</tr>
<tr>
<td>Compiling the report</td>
<td>Four weeks</td>
</tr>
<tr>
<td>Submission of report</td>
<td>One day</td>
</tr>
</tbody>
</table>

### SCHEDULE OF ACTIVITIES.

<table>
<thead>
<tr>
<th>ACTIVITIES</th>
<th>WEEKS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 2 3 4 5 6 7 8 9 10 11</td>
</tr>
<tr>
<td>Pilot Study</td>
<td></td>
</tr>
<tr>
<td>Data Collection</td>
<td></td>
</tr>
<tr>
<td>Data Analysis</td>
<td></td>
</tr>
<tr>
<td>Report Compilation</td>
<td></td>
</tr>
<tr>
<td>Report Submission</td>
<td></td>
</tr>
</tbody>
</table>

---

52
## APPENDIX 3

### BUDGET

<table>
<thead>
<tr>
<th>Activity</th>
<th>Cost</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proposal writing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Typing 35 pages @ Sh 30</td>
<td>1050</td>
<td></td>
</tr>
<tr>
<td>Photocopy @ Sh 1.50</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>Spiral binding @ 40</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Transport and miscellaneous</td>
<td>6000</td>
<td><strong>8350</strong></td>
</tr>
<tr>
<td><strong>Pilot study</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 copies of questionnaires @ Sh10</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Transport and miscellaneous</td>
<td>3000</td>
<td><strong>3200</strong></td>
</tr>
<tr>
<td><strong>Data collection</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 copies of questionnaires @ Sh 10</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Transport and miscellaneous</td>
<td>5000</td>
<td><strong>5300</strong></td>
</tr>
<tr>
<td><strong>Data analysis</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Data analysis services</td>
<td>3000</td>
<td></td>
</tr>
<tr>
<td>Transport and miscellaneous</td>
<td>4000</td>
<td><strong>7000</strong></td>
</tr>
<tr>
<td><strong>Project writing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Typing 70 pages @ Sh 30</td>
<td>2100</td>
<td></td>
</tr>
<tr>
<td>Photocopy @ Sh 1.50</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>Binding @ Sh 40</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>Transport and miscellaneous</td>
<td>4000</td>
<td><strong>8100</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>31950</strong></td>
</tr>
</tbody>
</table>
APPENDIX 4

LIST OF COMMERCIAL BANKS IN KENYA

1. Africa Investment bank
2. African Banking Corporation Ltd
3. Bank of Africa Kenya Ltd
4. Bank of the Bahamas Ltd.
5. Bank of India
6. Bank of Baroda (K) Ltd
7. Barclays Bank Of Kenya Ltd
8. CFC Stanbic Bank
9. Chase Bank (K) Ltd
10. Citibank N.A Kenya
11. City Finance Bank Ltd
12. Co-operative Bank Of Kenya Ltd
13. Commercial Bank Of Africa Ltd
14. Consolidated Bank of Kenya Ltd
15. Credit Bank Ltd
17. Diamond Trust Bank (K) Ltd
18. Dubai Bank Kenya ltd
19. East African Building Society Bank Ltd
20. Ecobank Ltd
21. Equatorial Commercial Bank Ltd
22. Equity Bank Ltd
23. Family Bank Ltd
24. Fidelity Commercial Bank Ltd
25. Fina Bank Ltd
27. Giro Commercial Bank Ltd
28. Guardian Bank Ltd
29. Gulf African Bank
30. Habib Bank A.G Zurich
31. Habib Bank Ltd
32. Housing Finance Bank.
33. Industrial Development Bank
34. Investment & Mortgages Bank Ltd
35. K-Rep Bank Ltd
36. Kenya Commercial Bank Ltd
37. Middle East Bank (K) Ltd
38. National Bank of Kenya Ltd
39. National Industrial Credit Bank Ltd (NIC)
40. Oriental Commercial Bank Ltd
41. Paramount Universal Bank Ltd
42. Prime Bank Ltd
43. Prime Capital and Credit Ltd
44. Savings and Loan (K) Ltd
45. Southern Credit Banking Corp. Ltd
46. Standard Chartered Bank (K) Ltd
47. Trans-National Bank Ltd
48. Victoria Commercial Bank Ltd

Source: Central Bank of Kenya