

**RELATIONSHIP OF CORPORATE GOVERNANCE PRACTICES
ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN
KENYA**

PRESENTED BY

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DECLARATION

This project is my original work and has not been presented in any university or college for award of a degree.

Mercelina Praxides Adhiambo

.....

Date.....

This project has been presented with my approval as the university supervisor.

Dr. Josphat Lishenga

Sign.....

Date.....

DEDICATION

This research study is dedicated to my beloved family for their positive contribution, constant encouragement and tireless reminders in pushing me to achieve this goal.

ACKNOWLEDGEMENT

This study would not have succeeded without the contributions of the following people: First, I thank the almighty God who gave the power and strength through the whole process. Secondly, I wish to acknowledge the professional advice and guidance of my supervisors Dr. Josphat Lishenga and Dr. Mirie Mwangi, who patiently and tirelessly guided me throughout the process of carrying out this project.

ABSTRACT

The study sought to establish whether there is a relationship between corporate governance practices and the financial performance of commercial banks in Kenya. The practices of corporate governance that the study focused on include board independence, board size and disclosure and board meetings. The study was anchored on agency theory, stakeholder theory and stewardship theory. The researcher used descriptive survey research design. In Descriptive Research, quantity data was collected and analyzed so that a specific phenomenon is described in its current trends, current events and it is linked with different factors at the current time. The study population in this case was all 43 Commercial banks in Kenya while the sample size was 28 banks. The study used secondary data obtained from banks' published reports, bank journals and periodicals. Secondary data was more useful for finding out the financial performance of the banks. Statistical tool for analysis (SPSS) and regression model was used to analyze data. The study used a multivariate regression model to establish the effect of corporate governance practices on financial performance of commercial banks in Kenya. The correlation results implied that corporate governance practices significantly affected the performance of commercial banks in Kenya. From the multivariate regression analysis the study established that corporate governance practices significantly affected performance of the commercial banks in Kenya. Board independence was found to enhance performance while board size and board meetings negatively affected the performance.

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LIST OF ABBREVIATIONS AND ACCRONYMS

C.E.O	Chief Executive Officer
NSE	Nairobi Security Exchange
OLS	Ordinary Least Square
PSICG	Public Sector initiative for corporate governance
ROA	Return on Asset
ROE	Return on Equity

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

According to the Public sector initiative for corporate governance in Kenya (PSICG, 1999), the founding of a suitable economic, institutional and legal surroundings that enable institutions to flourish as companies for advancing a lasting shareholder worth and utilizing person oriented growth at the same time as remaining mindful of their additional tasks to shareholders, setting and common humanity is known as corporate governance.

The concept of a company and corporate personality was recognized in the Code of Hammurabi, the first written law in western civilization. That was found in 1901 and it is still in existence. Good corporate governance arose mainly in rejoinder to the disconnection of possession and management due to the development of shared capital companies. The disjoining of possession and pedals which generates the principal-agent troubles emanating from the isolated ownership in the latest business have been the key focus of corporate governance, (Berle & Means, 1932). Often, corporate governance is termed as a means for the panel of directors' critical monitoring tool for reducing the troubles caused by the primary – agent association.

In corporate governance shareholders are regarded as principals while directors and managers are termed as agents. Whereby the agents are expected to work as per the principal interests and maximize the principal's wealth. But usually directors and managers make decisions that satisfy their interest. Managers make decisions to invest in high risk projects so that the banks get big profits. According to Donaldson and Davis (1991), the managers being the wardens are encouraged and pleased when a financial achievement is reached. This improves their public image.

1.1.1 Corporate Governance Practices

According to Public sector initiative for corporate governance in Kenya (PSIC 1999), corporate governance practices include independence of the board, competence of board members, board size, disclosure and board meetings. Board independence can be achieved when the directors' panel is believed to be self-regulating from the shareholders so as to ensure the panel's resolutions are not prejudiced by the shareholders. Central Bank of Kenya Act (2015), clarifies that to enhance independence of the board independent directors are not supposed to be less than a third of total board membership. Oxford English dictionary defines competence as "state of being able for a particular task". Banks need to select board directors who have relevant skills and expertise in the area of banking. That way the directors will be able to use their expertise to run the banks well.

Board size is about the number of the board members. The number can be big or small, but the CBK requires that institution licensed by the Banking Act should have a minimum of five directors. The maximum is not stated therefore each bank needs to set its own limit. According to (Ujunwa2012), large board size may bring more knowledge hence influencing the firm's performance positively. Dharmadasa et al. (2014), argue that board size leads to non-corporation and waste of time therefore their skills remain unutilized.

Board meeting is also one of the corporate governance practices. This is about the number meeting held by the board in a given period. Another aspect of corporate governance is disclosure. Disclosure is about publication of banks' financial statements. It's a requirement by law that all registered companies publish their financial statements. The research wants to find out how that affects the performance of commercial banks in Kenya. Barako, Hancock and Izan, (2006) observed that improved revelation of information minimizes firm's price of money by decreasing the unevenness of information. Therefore it enhances the firm's ability to raise capital at low cost hence increasing profitability. Wepukhulu (2016) recommended further studies on disclosure.

1.1.2 Financial Performance

The measure of bank's operations and policies in form of cash is termed as financial performance. It can also be defined as an overall measure of financial health of a firm above the provided time period and can be utilized in comparison with identical companies across the similar business. A bank's financial performance can be reflected in terms of Return on equity, Net profit, availability of Loanable funds and returns on assets. Net profit is the residual value after all expenses including tax have been deducted from the gross profit. It is an important measure of Banks' financial performance because that what the shareholders take home. Return on equity (R.O.E) measures bank's profitability by revealing how much profit it generates with the money common stock holders have invested in it (Wepukhulu 2016).

$$\text{R.O.E} = \frac{\text{Net Income}}{\text{Shareholders' equity}}$$

Net income is for the fiscal year before issuing dividends to ordinary shareholders but after paying dividends to preferred stockholders. And the stockholders' equity is not inclusive of preferred shares.

1.1.3 Commercial Banks in Kenya

Commercial banks, Central bank of Kenya, foreign exchange bureaus and Non-banking financial institutions all form a conglomerate of Kenya's financial sector. The Kenyan banks are typified by open structures working in unstable settings. According to Pearce and Robison (1997) the continued existence of banks relies on their capability fitting with the settings.

In Kenya commercial Banks play an important role as intermediaries. They mobilize resources by getting funds from investors, savings and sale of assets and distribute the money in terms of loans. Loans are issued at a higher interest rate than the rate on savings so that they realize profits. However, loans expose banks to the greatest level of risk that requires a good corporate governance to mitigate it. There are 42 licensed commercial banks in Kenya.

1.1.4 Corporate Governance and Commercial banks' Performance.

A bank's performance is determined by so many factors one of them being its corporate governance. Under corporate governance we have parameters like disclosure, auditors' and directors' independence, boards acting on behalf of stakeholders' interest and the size of the panel.

Since independence of the board is one of them, Fama and Jensen (1983) agreed with the sovereignty of the panel that it would decrease the agency fee thereby leading to profit maximization. Dharmadasa *et al*, (2014) also supports the same by saying that it increases firm efficiency. Mwongozo (2015) states that global corporate governance top activities exhibit strong connection amongst venture development, productivity and excellent governance.

1.2 Research Problem

According to Cadbury report (1992), corporate governance is a tool through which institutions are managed and directed. The board of directors and managers are expected to observe governance practices like panel of directors' size to improve banks' performance. According to Ujunwa (2012), a big panel size may carry additional information thereby influencing the firm's performance positively. But (Dharmadasa *et al*. 2014) argued that large board size contributes to non-compliance and misuse of occasion and consequently their skills remain unutilized hence affecting firm's performance negatively. Because these researches don't agree a further research needs to be done to verify the findings.

According to a Commonwealth report (1999) panel of directors' task is to make certain better corporate control. This entails a set of associations amongst the running of corporation, its panel, its shareholders and other significant stakeholders. It is important for the panel to concur on the corporation's objectives as well as principles and plan to attain its functions. Good corporate governance besides need the panel to the panel to ensure they manage the company with honesty. According to Boubakri (2011) failure to have better corporate management is a main reason of collapse of several sound

productive businesses. According to Stakeholders theory, a group of network which including the staff, business associates and suppliers are imperative apart from the owner – supervisor- employees’ connection in agency theory (Freeman, 1990). The two theories however, contrast each other and further research should be carried out.

Normally it is expected that directors and managers use the principles of corporate governance like integrity, disclosure, and accountability to run banks with the aim of maximizing shareholders’ wealth. But in reality the agents who are the directors and the management succumb to self-interest, opportunistic behaviors and fall short. They are usually in dilemma on the aspirations of the agents and principal quests.

In corporate governance the shareholders are regarded as chief and the directors while the managers are the agents. Whereby the agents are expected to work as per the principal interests and maximize the principal’s wealth. But usually directors and managers make decisions that satisfy their interest. Managers make decisions to invest in high risk projects so that the banks get big profits. According to Donaldson and Davis (1991), managers being the supervisors are pleased and encouraged when a bank’s goals are achieved. This improves their public image.

Barako Hancock and Izan, (2006) carried out research on impact of deliberate revelations of listed companies in Kenya and issues that may clarify such confession. They established that the assessment commission has an important aspect on the level of intentional confession. But researchers did not find out whether audit committee had an express effect on the productivity of the firms. Audit committee is important in internal control. And internal control being one of corporate governance practices, there is a need to discover if the audit committee there has a connection with the productivity of commercial banks in Kenya.

Ujunwa, (2012) found out that big panel size had an affirmative influence on firm’s productivity however, Dharmadasa *et al* (2014) posited that big board size negatively influences the firms productivity. This creates a gap to do a further research. Ochoi and Memba, (2002) examined how the corporate governance of selected public companies in Kenya affects the financial performance during the period 1998 to 2002. They established

that board members had a positive relationship with firm's fiscal performance. But their research did not specify whether relationship depended on the size of the board or its competence. Therefore this left a research gap of identifying specific corporate governance practice like board size or competence.

Currently in Kenya, some banks are facing receivership problems. A good example is the Chase bank and imperial Bank. Others like National bank of Kenya are experiencing liquidity problems. This puts corporate governance and its practices in Kenyan banks a subject to question. Therefore this study answered the following question. Is there a relationship between corporate governance practices and the financial performance of commercial banks in Kenya?

1.1.1 Research Gaps

Ujunwa (2012), States that a big panel size may carry additional information thereby influencing the firm's performance positively. But (Dharmadasa et al. 2014) argued that large board size contributes to non-compliance and misuse of occasion and consequently their skills remain unutilized hence affecting firm's performance negatively. Because these researches don't agree a further research needs to be done to verify the findings. Wepukhulu (2016), Carried out research on the same topic and suggested that further research be done one disclosure and board meetings.

1.1.2 Research Questions

1. Is there any relationship between corporate governance practices and bank's performance in terms of net profit?
2. If Yes, which kind of relationship i.e positive or negative relationship
3. Which type of bank performance measure banks prefer using more?

1.3 Objective of the study

To establish whether there was a relationship between corporate governance practices and the financial performance of commercial banks in Kenya.

1.4 Value of the study

The research is of immense value to the central bank of Kenya, investors, shareholders, academics and the government of Kenya. To the shareholders and government this research may help them to identify the average number of board members to appoint, since they are the ones who appoint the board members. The research may show whether a large number or smaller number of board members is better for the performance of the bank.

To the central bank, it may be able to know what is in place and what is missing that needs to be strengthened in order to avoid banks collapsing since it is the regulatory body of all commercial banks. To the investors they may be able to confirm whether there is good corporate governance and have confidence that their monies and assets are in good hands. For academics there will be referencing and suggestions on further investigation.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This section of the study details the theoretical background and defines the practices and principles of corporate governance in banks. It helps the researcher clarify the strengths and guide each stage of research from the formulation of topics to the utilization of literature on corporate governance and performance of commercial banks.

2.2 Theoretical Background

Theories are developed to clarify, forecast and comprehend phenomena as well as criticize the existing information. According to Torraco (2011), a theory comprises of ideologies and their joint definitions as well as available hypotheses that are intended for that specific research.

2.2.1 Agency Theory

Stephen Ross and Barry Mitnick were the initial scholars to suggest openly that a theory of agency be produced essentially starting with its formation. This was advanced thereafter by Jensen and Meckling (1976). The association between the premiers such as agents and shareholders also referred to as business executives and manager is known as agency theory. The shareholders are the principals or are the ones who own the business and therefore they employ the agents to carry out the job. The running of the business by the managers or directors who are the owners' agents is often delegated by the principals (Clarke, 2004).

Agency theory aims to guarantee that supervisors or the managers operate in shareholders greatest interest (Jensen, 1976). Interests of shareholder include making profits or wealth maximization. The board and the directors are the agents and the shareholders are the owners of the bank. The board and the directors work towards the realization of shareholders interest of maximizing their wealth. Public sector initiative for corporate

governance in Kenya (PSICG 1999) states that corporate governance enable institutions to flourish as companies and advancing a lasting shareholder worth.

2.2.2 Stakeholder Theory

The theory was entrenched in the organizations order in 1970 and ultimately advanced by Freeman (1984) factoring in busies accountability to a wide range of stakeholders. The persons as well as the population that facilitate either willingly or unwillingly to its affluence generation ability and actions are referred to as stakeholders. Post *et al* (2002) posits that stakeholders are consequently the likely benefactors as well as the bearers of threats.

According to Freeman (1984) Stakeholder theory posits that businesses must devise their company policies taking into account their stakeholders' interest. Stakeholder theory proposes that supervisor in a firm should have a set of connections for the association to operate. This network contains the staff, business associates and suppliers. Nonetheless in a broader perspective, business governance moreover entails the association with a wider array of company stakeholders mutually inner ones such as staff and outside ones such as suppliers and clientele (Ayuso & Argandona, 2007). The title and the theory bear participation of the stakeholders'.

For the board who are the agents to maximize the shareholders' wealth the needs to work with other stakeholders like the creditors or investors who will bring funds for loans. The directors and the mangers have to put the customers into consideration so that they get people to lend the money to, so that they make profits for shareholders. There should be employees of the bank to offer banking services. Therefore this theory is relevant since other people apart from shareholders are required to realize the goal of the shareholders by banks performing well.

2.2.3 Stewardship Theory

The origin of stewardship theory is derived from sociology and psychology. Davis, Schoorman and Donaldson (1997) posit that wardens safeguards and exploits shareholders affluence in the course of company performance as a result wardens' efficacy utility are exploited. In such a scenario, managers functioning for the shareholders guards and create earnings for the shareholders while the wardens are the executives. Stewardship theory comes short in emphasizing the perception of distinctiveness in contrast with the agency theory except rather on the task of higher executive acting as stewards while incorporating their objectives as an element of the business, (Donaldson & Davis, 1991).

2.3 Determinants of Performance in Bank

2.3.1 Corporate Governance

Public sector initiative for corporate governance in Kenya (PSICG, 1999) describes it as a foundation of a correct lawful, institutional and economic setting that permits firms to prosper. Companies or banks appoint directors and managers to facilitate in creating that environment. Directors and managers being the top body of governance are accountable for developing ideals and principles inside the business through judgments, enticements and in-house management structures (Ayuso and Argandona, 2007). Banks performance depends on the decisions made by the directors and the bank management. It also depends on internal control systems since this helps in reducing risks occurrences.

2.3.2 Maturity of Banking Sector

Maturity of Banking Sector leads to high number of commercial banks. This raises competition, hence making commercial banks not able to perform to their maximum levels. Failure to perform to maximum levels reduces performance (Sufian & Chong, 2008).

2.3.3 Revenues and Deposits

The ability to attract more customers affects customer deposits in banking sector. An increase in the number of customers' increases the deposits hence increasing revenue for loans. When banks issue out loans they are able to get profit from the interest charged.

2.3.4 Cost of Operations

The operating costs of a bank are normally expressed as a percentage of the profits and they are normally expected to influence the financial performance of a bank in a negative manner (Murerwa, 2015). One of the measurements of financial performance of bank is the profits. And profit is obtained expenses or costs have been deducted from total income. That means when costs are high the profits will reduce.

2.4 Empirical review

Letting, Aosa and Machuki, (2012) sought to look at board diversity association with the financial performance of firms listed in the Nairobi Securities Exchange. The target population for the research comprised of listed firms in the Nairobi Securities Exchange (NSE) as at 31st December 2010. At that particular period 47 firms were working in different segments of Kenya's economy. The study incorporated all the firms. A census survey was adopted for the research. The study used structured questionnaire to collect data for the board on their sex, age, level of educational, study specialty and panel area of interest in addition to the firms' financial performance. The findings obtained through an Ordinary Least Squares (OLS) regression revealed that board diversity had a weak positive relationship with financial performance apart from the independent outcome of panel study specialty on share return. The findings partly agree with resource dependency and agency theories of corporate governance.

Another study by Morekwa (2013) assessed the effects of governance on commercial banks' performance in Kenya. The target population for the research was 44 commercial banks in Kenya. The study used Return on Assets and Return on Equity as measures of performance and 3 dependent variables while the independent variables used to measure governance comprised of C.E.O duality, independent directors and board size. The study

adopted a panel econometrics technique to examine the association between the variable of governance and bank performance. The study findings revealed that large board size negatively impacts performance while board of directors' independency enhances banks' performance. Further, the study revealed no evidence on the impact of C.E.O duality or otherwise on commercial banks performance in Kenya.

Barako, Hancock and Izan (2006) also conducted a study to determine company's voluntary disclosure impact as well as issues that may clarify such revelation. The research detailed a longitudinal assessment of deliberate confession activities in the listed companies in Kenya's yearly financial reports. The study evaluated the degree to which ownership structure, corporate governance attributes as well as company characteristics affect voluntary revelation. The study used weighted disclosure index. The target population for the study was 54 publicly listed firms in NSE. The findings of the study indicated that company's attributes of corporate governance, company characteristics and ownership structure affects the degree of voluntary disclosure.

Moreover, Mang'unyi (2011) sought to examine the effects of corporate governance and ownership organization on the performance of firms in Kenya with regard to banks. The main aim for the study was to determine the association between ownership structure and performance of the banks in Kenya as well as ownership structure and corporate governance. The study adopted survey design. The target population for the study consisted of banks that are located Nairobi Kenya. The research used stratified sampling to pick the banks. The final sample size used by the study was 40 bank managers. The findings of the study showed that ownership type had no significant difference with financial performance as well as between corporate governance practices and banks ownership organization. Additionally, the results indicated corporate governance had a significant difference with financial performance of banks. On the other hand, results showed that foreign-owned banks had a slight better performance than local banks.

Ochoi and Memba (2002) examined how the corporate governance of selected public companies in Kenya affects the financial performance during the period 1998 to 2002. Financial performance was measured by use of profitability. The study mainly focused on

public listed in Nairobi securities exchange. A sample of public 26 companies was drawn using purposive sampling. The study adopted both inferential and descriptive statistics. The study further used a multiple linear regression model for data analysis. Results of the study showed that corporate governance practices had a strong association with the firms' financial performance. The findings also showed that board members had a positive relationship with firm's financial performance. However, results of the study do not indicate how the management used budgets, successive leadership, planning and more professional cooperation between the management and the board. The study recommends that management tenure and remuneration should be appropriately tackled to enhance incentive on management

Another study by Black (2001) sought to examine the connection between corporate governance and firm value. The target population for the study was 21 Russian firms. The study also used partial control variables as a proportion of the speculative market value. Results of the study revealed that a change in corporate governance significantly increases firm market value and scores from the lowest to the highest rank. Despite the trouble in describing uncontested measures of firm performance and controlling correctly for all non-corporate governance interrelated issues, which most definitely will emphasize prospective study in this, the issue to be answered depends on the likelihood of contrary causality. The study further indicated that performance may compel to a certain degree a stronger conformity with corporate governance requirements. Hence, like the investigation of the resolve of the set of corporate governance policies for a specific company, once more may result in a proper condition of the corporate governance predicament in the situation of performance analysis may have to assume endogeneity in deliberation. The research was carried out at a period when Russian corporate was at the lowest point with big disparity among companies and a large portion of firms' worth at stake through company's government options.

Agrawal and Knoeber, (1998) conducted a study whose main objective was to undertake a corporate study of corporate governance and its conflict of interest over compensation. A total of 450 firms were used as the study sample that was divided into two sets. The

first set comprised of managers who were exposed to risk as well as competition effects while the second set comprised of managers only exposed to competition effect. Multiple regression analysis were used to examine whether the existing corporate governance mechanism has conflict of interest over compensation. They observed dual and divergent effects of takeover threat on compensation. The first effect comes in the manner of competition effect occurring in the market for managers, subsequently making managers less capable of obtaining higher wages. The next involves risk effect that leads to bigger compensation contrary to the first as greater takeover threat is more probable to lead to bigger likelihood of firm-specific human capital loss or indirectly deferred compensation. Consequently managers claim increased pay to offset increased risk.

As postulated, the two effects are noted to have immense significance implying therefore that *ceteris paribus*, a higher pay results from a lower takeover threat through the competition effect in harmony with the false perception of misalignment of interests between shareholders as well as managers.

Fama, (1980) conducted a study whose main objective was to establish the influence of corporate governance in relation to managerial labour market as well as mutual monitoring by managers. He contends that there is a stake by every manager in the performance of those directly below or above him/her in management. Subsequently, he/she carries out some extent of monitoring that runs in both directions. Primary Data for the study was based on direct observation, interviews as well as surveys through the use of structured questionnaires. He found that these executives are entitled to close to one-third fewer positions on other companies managerial boards. Furthermore, he found out that the labour market differentiates between two types of managers; those who are displaced from their prior positions based on reasons outside their control as well as managers who were directly associated with the institution's failure. Additionally, he put forward the argument that managers laid off because of banks that collapse for reasons indisputably outside their control are twice more expected to reclaim similar banking positions than the other category of managers who cause bank failure. He contended that the weight of revising the wage ought to be adequate in order to resolve any

unforeseeable challenges but conceded that market imperfections lead to the models fail since managers will constantly be rewarded for the alignment extent they achieve with the interest of the shareholders.

Jensen and Meckling (1976) sought to establish the effect of debt policy on corporate governance and corporate governance performance. The study rationalized debt as a tool for minimizing agency issues in numerous ways. The target population for the study comprised of 200 samples divided into 2 groups of low concentrated ownership structure entailing firm shares owned by the largest shareholder from 25% to less than 50% high and concentrated ownership constituting firm shares owned by the largest shareholders as 50% or more. The study findings indicated that debt can decrease a firm's flexibility since interest costs are rigid and this rigidity may result in sub-optimal administrative risk taking. The price and the application of debt as an administrative examination instrument are prone to change between firms due to the volume, level of physical property that may be used as security, company personality, firm's threat, and ownership arrangement. Since several companies particularly those with unstable earnings or little concrete assets, preserving a significant point of debt may be very unreasonable, and modest degree of debt may not result into an adequate connection dedication to regulate managers. Furthermore, debt-holders normally may be unwilling to perform their duty to file for their defaulter's insolvency and may favor out of the court arrangements, particularly when they have big monetary risks at stake. Therefore, in terms of its managerial regulating function, debit can maybe best be viewed as setting a lowest efficiency prerequisite on management, through which managers may digress from excellence with an element of impunity.

Farinha and Jorge (2003) also conducted a study to examine the effect of dividend policy on corporate governance. The target population for the study was Globe and Mail firm in Canada to examine dividend payouts. The study sought to establish if dividends and insider ownership are alternative tools for supporting the interests of managers and shareholders. Results of the study showed that dividend strategies have also been viewed as extra possible inner plans to minimize equity agency fees. Therefore, a growing

agreement exists in terms of administrative supervisory duty for dividend strategy where latest experimental findings have been enchanting away the focal point from indication or tax support as the major clarification for corporate shares. The study utilized Globe and Mail firm as the sole measure of firm level of governance however other government constructs may result to different findings. Also the study should have also examined the association among overall governance quality and financial and strategic decisions such as mergers, credit ratings and acquisitions

2.5 Conceptual Framework

Independent variable

Corporate Governance Practices

Dependent variable

Financial Performance

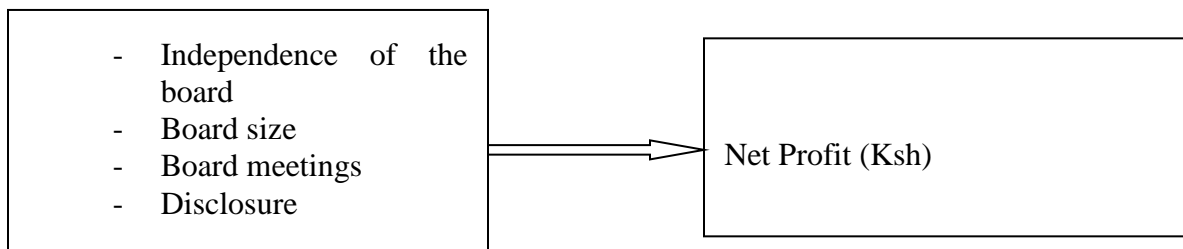


Figure 2.1: Conceptual Framework

Expected relationships among the variables

The researcher expects a positive relationship between board independence and net profit of Banks. When the board is independent net profit will increase. This is because board independence will reduce agency costs hence increasing profits. The research expects a positive relationship where there will be large board size. That is because of the higher the number the more knowledge will be brought to the bank hence influencing profits positively. Finally, the researcher also expects positive relationship between disclosure and net profits as this influences investments and capital of the bank.

2.6 Summary of Literature Review

The researcher used three theories. These are the shareholder theory, stakeholder theory and steward theory. Shareholder and stakeholder theory both refer to directors and managers as agents and the shareholders and stakeholders as the owners of the firm. They both agree that agents work on behalf of the principals, and they should act as per the interests of the principals. But the two theories disagree on scope of the people to whom agents should work for their interest.

Shareholders theory states that agents should work for the interest of shareholders who are the owners. But stakeholder theory extends the interest to all stakeholders; this includes the employees, suppliers or creditors, customers and investors. Stewardship theory argues that people are collective minded and pro organizational rather than individualism. Because of that managers will work towards the attainment of organizational goals. By doing so they get a high level of satisfaction, this means they work for their own self-interest.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the research design, and the methodology the researcher will use to carry out the research. This represents research design, research population, sample size sampling procedure, data collection and analysis.

3.2 Research Design

Research design is the way a study is designed. The researcher used descriptive survey research design. In Descriptive Research, quantity data is collected and analyzed so that a specific phenomenon is described in its current trends, current events and it is linked with different factors at the current time. The researcher used descriptive research design to enable generalization of the findings to larger population. This study therefore was able to generalize the findings to all commercial banks in Kenya.

3.3 Study Population

Mugenda and Mugenda, (2003) defines population as an entire group of individuals, events or objects having a common observable characteristic. Since a population is having common characteristics then that mean that the population should be homogeneous. They study population in this case was all 43 Commercial banks in Kenya.

3.4 Sample

According to (Mugenda and Mugenda, 2003) a sample is a smaller group obtained from accessible population to be a representative of the whole population. As at June 2016 central bank report indicated that they are 43 commercial banks in Kenya. Central bank has grouped them into three subgroups namely Tier 1, Tier 2 and Tier 3 according to the volume of their asset base. Tier 1 comprises of old banks that have accumulated assets and their possibility to fall into financial crisis is near to impossible. This sub group has a

total number of six banks. Tier 2 has total of nine banks and Tier 3 has a total of 29 banks.

Since commercial bank has grouped these banks in sub groups, the research used stratified sampling, whereby these Tiers were her subgroups. The researcher then calculated the sample size basing on the sub groups.

Commercial banks

Tier 1	Tier 2	Tier3
6 banks	8 banks	29

Since the total number of commercial banks was less than 10,000 the study used the formula;

$$nf = \frac{n}{1 + n/N}$$

Where n is the desired number

N - the total population in

In Tier 1 the researcher's desired number is 1 bank. Therefore sample size from Tier 1 then was;

$$nf = \frac{1}{1 + 1/6} = 3$$

Tier 2, the desired sample is 2 banks

$$nf = \frac{2}{1 + 2/8} = 5$$

Tier 3 the researcher's desired sample 2

$$Nf = \frac{2}{1 + 2/29} = 20$$

The sample size will be 28 banks.

3.4 Data collection

The study heavily relied on the secondary data. Secondary data was obtained from banks' published reports, bank journals and periodicals. Secondary data was more useful for finding out the financial performance of the banks.

3.4.1 Measurement of Variables

The study operationalized corporate governance as independence of the board, Board Size, Board Meetings and Disclosure while performance was measured as net Profit. Table 3.1 shows how the variables were measured.

Table 3.1 Measurement of the Variables

Variable	Type	Measurement
Independence of the board	Independent Variable	Ratio of Non-executive Members to the total number of board members
Board Size	Independent Variable	Number of board members
Board Meetings	Independent Variable	Number of board meetings
Disclosure	Independent Variable	Binary Variable (1 = they bank discloses financial information, 0 = the bank does not disclose financial information)
Net Profit	Dependent Variable	Amount of Profits / Loss

3.5 Data Analysis

Data analysis is a systematical identification, arrangement, organization samples were paired so that the researcher can calculate the correlations coefficient between dependent

and independent variables. Statistical tool for analysis (SPSS) and regression model was used to analyze data.

3.5.1 Regression Model

A multivariate regression model was used to establish the effect of corporate governance practices on financial performance of commercial banks in Kenya. A multivariate regression model was considered since the independent variables are more than one.

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where:

Y is the Financial Performance (Net profits)

X₁ is Independence of the board

X₂ is Board size

X₃ is Number of board meetings

X₄ is Disclosure

β_0 is the regression constant or intercept,

β_1 , β_2 , β_3 , and β_4 are the unknown parameters (regression coefficients)

ε is the error term,

3.5.2 Test of Significance

The study conducted all statistical tests at 5% level of significance.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND DISCUSSION

4.1 Introduction

This chapter contains data analysis presentation and discussions of the findings. The study used both descriptive and inferential statistics in analysis. The descriptive results included both measures of central tendency and trend analysis while inferential comprised of the correlation analysis and regression analysis.

4.2 Descriptive Statistics of the Variables

Descriptive statistics were carried out to establish the measures of central tendency of the study variables. These include mean, standard deviation, minimum and maximum values for all the variables under study. The results are presented in Table 4.1.

Table 4.1 Descriptive Statistics of the Variables

Variable	Minimum	Maximum	Mean	Std. Deviation
Non-Executive Members	3	14	7.79	2.807
Executive Members	1	6	2.00	1.361
Board Independence	0.60	12.00	5.2446	2.93357
Board Size	6	20	9.79	3.392
Board Meetings	4	21	7.67	4.715
Disclosure	1	1	1.00	0.000
Net Profit	-326431.0	306165.0	4039.26	122848.69

The results showed that commercial bank with the lowest non-executive board members had 3 while that with maximum had 14. However, majority of the banks had 7 non-executive members as shown by the mean of 7.79. The findings further showed that majority of the selected commercial banks had 2 executive board members with the banks with maximum having 6 executive members. The study computed board independence by dividing the numbers of non-executive members by that of executive members. High the ratios of non-executive members to executive members indicated high board independence. The finding indicated that 5.2 which implied that majority of the

commercial banks had many non-executive board members compared to executive members.

The study further revealed that majority of the commercial banks had a board size of 9 members with that with highest number having 20 while that with the least number having 6 as shown in table 4.1. These findings implied that majority of the commercial bank neither had a lean or bloated board size. The study further sought to establish the number of board meetings held by the commercial banks boards. The results indicated that majority of the commercial banks held 7 meetings per years as shown by the mean. The results further showed that 21 and 4 were the maximum and minimum number of meeting held by board of commercial banks in Kenya. The study finally established that all the banks disclosed their annual financial reports. Therefore, these this variable was henceforth withdrawn from the preceding analysis.

4.3 Trend Analysis of Corporate Governance and Performance

This section provides the results of the trend analysis used to show the relationship between corporate governance of various selected banks and their respective performance as measured by the net profits. The findings are presented in figures 4.1 to 4.2.

4.3.1 Trend Analysis of Board Independence and Performance

The study sought to establish the trend in board independence and performance of selected banks in Kenya. The results are presented in figure 4.1.

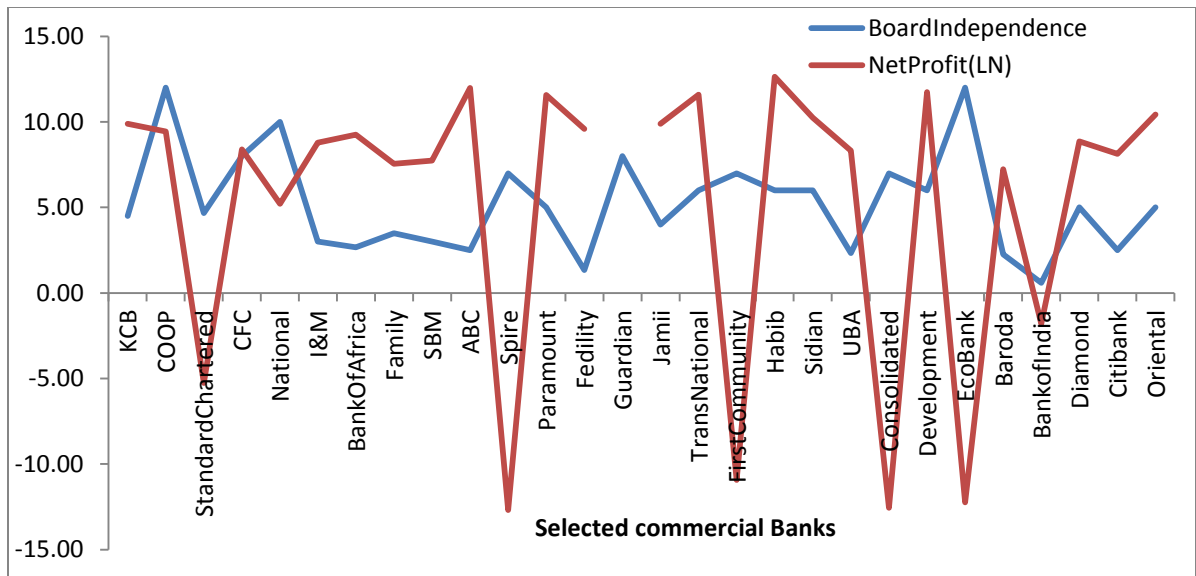


Figure 4.1 Trend Analysis of Board Independence and Performance

The finding presented in figure 4.1 indicated that board independence fluctuated across different banks. Cooperative bank and Eco bank had the highest board independence among the selected banks. These findings implied that there was a change in board independence across various selected commercial banks. The findings implied that different commercial banks practiced different level of board independence.

4.3.2 Trend Analysis of Board Size and Performance

The study also sought to establish the relationship between board size and performance of selected commercial banks in Kenya. The results presented in figure 4.2 shows the trend analysis for board size and performance across various selected commercial banks.

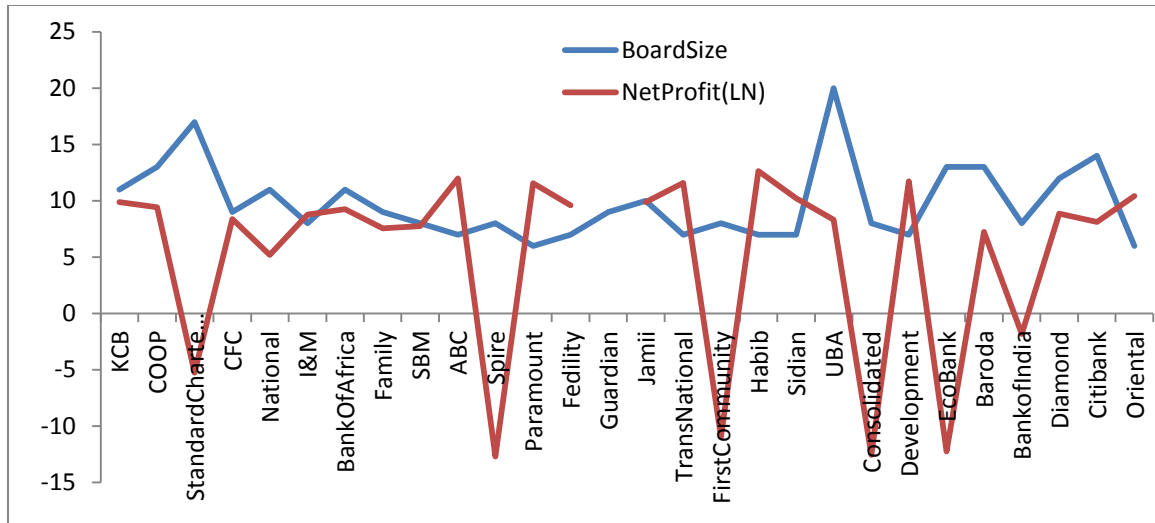


Figure 4.2 Trend Analysis of Board Size and Performance

The result presented in figure 4.2 shows that the size of the board varied from one commercial bank to the other. The bank with the largest board size was UBA bank while paramount bank had the smallest board size. The results showed that standard chartered bank had the largest board size which coincided in loss in performance. Generally the banks with moderate board size recorded high performance as shown in figure 4.2. These included ABC, Paramount and Habib among others. These findings could imply that having moderate board size enhances the performance of commercial banks.

4.3.3 Trend Analysis of Board meetings and Performance

The study finally sought to establish the relationship between the number of board meetings and performance as measured by the net profits. The findings presented in figure 4.3 shows the relationship between number of board meetings and performance of selected commercial banks in Kenya.

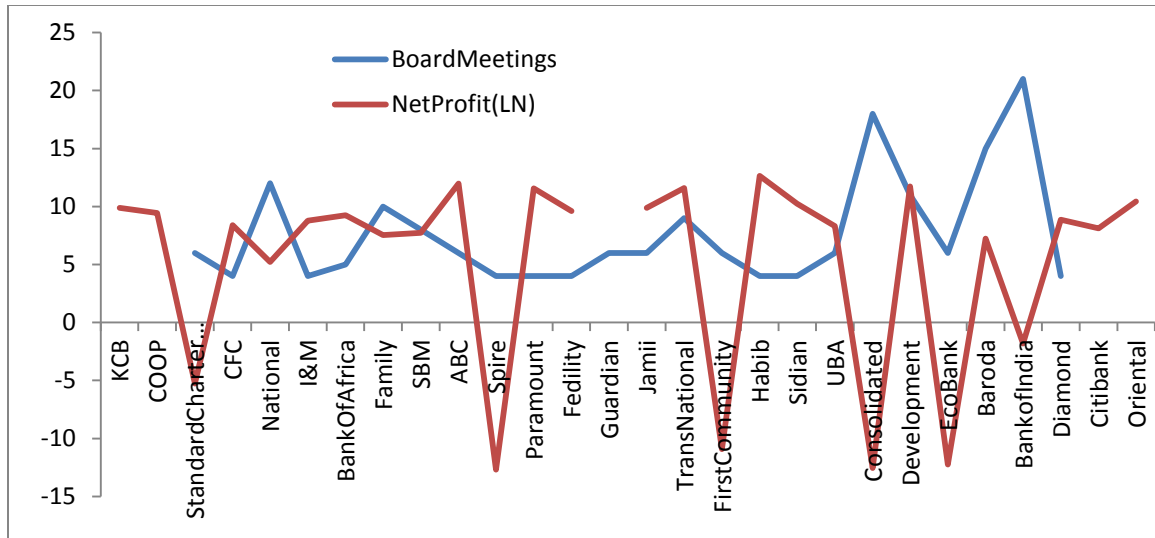


Figure 4.3 Trend Analysis of Board Meetings and Performance

The findings presented in figure 4.3 indicated that consolidated bank and Bank of India were the banks that held numerous board meetings. The banks with the least board meetings were among others CFC Stanbic Bank, I&M Bank, Paramount Bank and Diamond Banks among others. The trend analysis further showed that commercial with moderate number of meetings also recorded good performance. However, consolidated banks and Bank of India that held many board meetings also recorded negative performance during the time of the study. These findings could imply that many board meetings arise from the need to address poor performance the banks could be experiencing.

4.4 Inferential Statistics

This section provides the results for inferential statistics which included correlation and regression analysis. The study used correlation analysis to test the association between the study variables while regression was used to test the relationship between independent variables and dependent variable.

4.4.1 Correlation Test Results

The study used Pearson correlation to test the association between corporate governance practices and performance of commercial banks in Kenya. The findings are presented in table 4.4.

Table 4.2 Correlation Matrix

		Board Independence	Board Size	Board Meetings	Net Profit(Ksh)
Board Independence	Pearson Correlation Sig. (2-tailed)	1			
Board Size	Pearson Correlation Sig. (2-tailed)	-0.600 0.001	1		
Board Meetings	Pearson Correlation Sig. (2-tailed)	-0.434 0.024	0.454 0.017	1	
Net Profit	Pearson Correlation Sig. (2-tailed) N	0.552 0.003 28	-0.475 0.012 28	-0.431 0.028 28	1 28

The findings presented in Table 4.2 shows that board independence and Net profits of commercial banks had a strong, positive and significant association. This was shown by the Pearson Correlation value of 0.552 and p-value of 0.003. These findings implied that an increase in board independence could lead to an increase in net profit of commercial banks in Kenya.

Similarly, the findings showed that board size and Net profits of commercial banks had a strong, negative and significant association. This was shown by the Pearson Correlation value of -0.475 and p-value of 0.012. These findings implied that an increase in board size could lead to a decrease in net profit of commercial banks in Kenya.

Finally, the study sought to establish the association between board meetings and net profits of commercial banks. The correlation results presented in Table 4.2 indicated the

existence of a weak negative and significant relationship between board meetings and net profits of commercial banks in Kenya. This was shown by the Pearson Correlation value of -0.431 and p-value of 0.028. These results implied that increasing the number of board meeting leads to decrease in performance. Overall the results implied that corporate governance practices significantly affected the performance of commercial banks in Kenya.

4.4.2 Multivariate Regression Results

The study finally employed the multivariate regression analysis to test the relationship between the independent variables and the dependent variable. The findings of multivariate regression analysis are presented in table 4.3 to 4.5.

Table 4.3 Model Summary

Model	R	R-Square	Adjusted R-Square	Std. Error of the Estimate
1	0.901	0.812	0.786	3.9227499

a. Predictors: (Constant), Board Meetings, Board Independence, Board Size

The results presented in table 4.3 indicated that corporate governance practices (board meetings, board independence and board size) jointly accounted for 81.2% (as shown by R-Square =0.812) of the variation in the commercial banks' net profits. These findings could be deduced to imply that corporate governance practices accounts for the larger percentage in the variation of performance of commercial banks.

Table 4.4 Analysis of Variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	1457.452	3	485.817	31.571	.000
1	Residual	338.535	22	15.388		
	Total	1795.987	25			

a. Dependent Variable: Net Profit

b. Predictors: (Constant), Board Meetings, Board Independence, Board Size

The findings of ANOVA presented in table 4.4 indicate that the model used to link the predictor variables (corporate governance practices) to the performance of commercial banks was statistically significant as shown by F-statistics=31.571 and p-value =0.000. These findings implied that board independence; board size and board meetings were significant predictors of performance of commercial banks.

Table 4.5 Regression Coefficients Results

Predictor Variables	Beta	Std. Error	t-statistic	Sig.
(Constant)	10.349	4.235	2.444	0.023
Board Independence	1.026	0.286	3.584	0.002
Board Size	-0.984	0.274	-3.597	0.002
Board Meetings	-0.501	0.201	-2.496	0.021

a Dependent Variable: Net Profit

The findings presented in table 4.5 indicate that board independence had positive and significant relationship with net profits ($\beta=1.026$, $p=0.002$). These findings implied that an increase in board independence would lead to increase in net profits of commercial banks. The results further implied a unit increase in board independence would results to an increase of 1.026 units in the net profits of commercial banks in Kenya.

On the relationship between board size and net profits, the regression results indicated that there existed a negative and significant relationship between board size and net profits ($\beta=-0.984$, $p=0.002$). Therefore these findings implied that increase in board size lead to a reduction in net profits. A unit increase in board size would lead to reduction of -0.984 units in net profits of commercial banks in Kenya.

Finally, the study sought to establish the relationship between the number of board meetings and performance of commercial banks in Kenya. The findings of regression analysis showed that the number of board meetings was negatively and significantly related to the net profits of commercial banks in Kenya. Increasing board meetings negatively reduce the performance of commercial banks.

4.6 Discussion of the Results

The study sought to establish whether there is a relationship between corporate governance practices and the financial performance of commercial banks in Kenya. The practices of corporate governance that the study focused on include board independence, board size and disclosure and board meetings. Financial performance of commercial banks was measured using net profits. From the data analysis the study established that corporate governance practices significantly affected the performance of the commercial banks in Kenya. Board independence was found to enhance performance while board size and board meetings negatively affected the performance.

The findings of this study agrees with those of Ayuso and Argandona (2007) who established that directors and managers being the top body of governance are accountable for developing ideals and principles inside the business through judgments, enticements and in-house management structures. Aosa and Machuki, (2012) findings on the other hand, revealed that board diversity had a weak positive relationship with financial performance apart from the independent outcome of panel study specialty on share return

The study findings further concurred with another study by Morekwa (2013) whose findings revealed that large board size negatively impacts performance while board of directors' independency enhances banks' performance. Mang'unyi (2011) also indicated corporate governance had a significant difference with financial performance of banks. Finally, Ochoi and Memba (2002) findings showed that board members had a positive relationship with firm's financial performance.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This section contains the summary of the study findings, conclusion of the study and recommendations based on the study findings that the study made. The section also provided suggestions for future studies.

5.2 Summary

The study sought to establish whether there is a relationship between corporate governance practices and the financial performance of commercial banks in Kenya. The practices of corporate governance that the study focused on include board independence, board size and disclosure and board meetings. The study was anchored on agency theory, stakeholder theory and stewardship theory. The researcher used descriptive survey research design. In Descriptive Research, quantity data was collected and analyzed so that a specific phenomenon is described in its current trends, current events and it is linked with different factors at the current time.

They study population in this case was all 43 Commercial banks in Kenya while the sample size was 28 banks. The study used secondary data obtained from banks' published reports, bank journals and periodicals. Secondary data was more useful for finding out the financial performance of the banks. Statistical tool for analysis (SPSS) and regression model was used to analyze data. The study used a multivariate regression model to establish the effect of corporate governance practices on financial performance of commercial banks in Kenya.

The correlation results implied that corporate governance practices significantly affected the performance of commercial banks in Kenya. From the multivariate regression analysis the study established that corporate governance practices significantly affected performance of the commercial banks in Kenya. Board independence was found to

enhance performance while board size and board meetings negatively affected the performance.

5.3 Conclusions

The study established the existence of significant relationship between corporate governance and performance of commercial banks in Kenya. The study made the following conclusion; first, commercial banks that have non-executive board members enhance independence. Independence in board ensures that no biased in the decision making by the board. This ensures all decision made are made with the interest of the banks and not individual benefits. The study also concluded that to enhance performance commercial banks board independence must be realized. From the findings, the study concluded that boards of commercial banks must have high level of independence, diversity, size and have quality meetings in order to execute their roles and mandate effectively. This will enhance the quality of their financial performance.

5.4 Recommendations

Based on the findings of this study, the following recommendations were made; the study recommended that all commercial banks should balance the non-executive members and executive members in their boards to have high level of independence. The board that is all inclusive is effective in exercising its mandate which is likely to impact positively on the firm financial performance.

The study further recommended that boards should not be too bloated or too lean. The board should be in a manner that all the board members have specific role and duties to avoid duplication of roles. It is therefore recommended that the number of directors serving on the corporate board should be moderate to improve corporate governance by the board of directors and to also improve firm performance.

Finally the study recommends that board of directors should hold adequate, quality and meaningful meetings that are directly toward enhancing the strategic performance of their banks. Increasing the frequency of committee meetings leads to more effective board

operations, therefore committee members ought to be willing to devote more of their time for auditing.

5.5 Suggestions for Future Research

Corporate governance is a wide area of study that covers many factors other than the ones covered in this study. The study therefore recommends further studies should focus on other aspects of corporate governance practices not covered in this study such as the effect of the number of board committees on performance as well as the effect of ownership concentration on performance. Since this study was conducted on selected number of commercial banks, further studies should be carried out to focus on the whole sectors players for comparison purposes. The study recommends that future studies can consider using other indicators of performance other than net profits such as returns on asset, returns on equity or Tobin Q.

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APPENDIX I: Data Collection Sheet

Banks	Non-Executive Members	Executive Members	Board Independence	Board Size	Board Meetings	Disclosure	Net Profit (Ksh 000)
KCB	9	2	4.50	11	8	1	19,859,000
COOP	12	1	12.00	13		1	12,600,000
Standard Chartered	14	3	4.67	17	6	1	-191
CFC	8	1	8.00	9	4	1	4,400,000
National	10	1	10.00	11	12	1	183
I&M	6	2	3.00	8	4	1	6,500,000
Bank Of Africa	8	3	2.67	11	5	1	10,470
Family	7	2	3.50	9	10	1	1,900,000
SBM	6	2	3.00	8	8	1	2,309
ABC	5	2	2.50	7	6	1	160,560
Spire	7	1	7.00	8	4	1	-326,431
Paramount	5	1	5.00	6	4	1	106,288
Fidelity	4	3	1.33	7	4	1	14,711
Guardian	8	1	8.00	9	6	1	
Jamii	8	2	4.00	10	6	1	19,600
Trans National	6	1	6.00	7	9	1	109,130
First Community	7	1	7.00	8	6	1	-55,734
Habib	6	1	6.00	7	4	1	306,165
Sidian	6	1	6.00	7	4	1	28,048
UBA	14	6	2.33	20	6	1	4,100,000
Consolidated	7	1	7.00	8	18	1	-281,632
Development	6	1	6.00	7	11	1	125,620
Eco Bank	12	1	12.00	13	6	1	-204,958
Baroda	9	4	2.25	13	15	1	1,383.14
Bank of India	3	5	0.60	8	21	1	-6.089
Diamond	10	2	5.00	12	4	1	7,100,000
Citibank	10	4	2.50	14		1	3,400,000
Oriental	5	1	5.00	6	5	1	33,686