THE IMPACT OF AGENCY COSTS ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

It’s my humble declaration that the work contained in this research project is my original work and has not been presented in any other institution for examination for degree level or any other academic hierarchies.

Linda Nasimiyu Wanyonyi

D61/84052/2015

Signature…………………………………… Date……………………………

This research project submitted for examination with my approval as the Supervisor by the University.

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School of Business, University of Nairobi

Signature……………………………………………… Date……………………………
DEDICATION

I dedicate this study to my late parents Mr. Samuel Wanyonyi Wasike and Mrs. Gladys Nangila Mbirira as they motivated me in my earlier years to achieve in life.
ACKNOWLEDGEMENT

Sincere gratitude to God for giving me good health, strength and resources to complete the program successfully. I acknowledge my supervisor Mr. Martin Odipo for his tireless efforts, guidance and commitment in the development and completion of this research project. Special thanks to all my lecturers in the MBA program for their wise counselling and encouragement throughout the duration of the course.

Appreciation and profound thanks to my family members for their inspiration and love for education. My Uncle Stephen Mutoro for always believing in me and giving me the motivation to move forward. My brother Kelvin Wasike for giving me a reason never to give up in life.

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<tr>
<td>CBK</td>
<td>Central Bank of Kenya</td>
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<tr>
<td>CRB</td>
<td>Credit Reference Bureau</td>
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<tr>
<td>FCF</td>
<td>Free Cash Flows</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>KCB</td>
<td>Kenya Commercial Bank Limited</td>
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<td>MM</td>
<td>Modigliani and Miller</td>
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<td>NGO</td>
<td>Non-Governmental Organizations</td>
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<tr>
<td>ROA</td>
<td>Return on Asset</td>
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<td>SPSS</td>
<td>Statistical Package for Social Science</td>
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ABSTRACT

Agency costs stem from conflicts of interests that exist in a principal-agent relationship. The relationship is usually created since the principal may not be in position to undertake the tasks, either due to lack in technical know-how, or any other factor that would make it essential for the principal to seek the services of an agent. There are various principal-agent relationships in a commercial bank with the most common being shareholder versus management relationship. Agency costs are hereby incurred with the aim of aligning the goals of the agents to those of the principal and therefore lead to achievement of the principal’s overall goals. This study was therefore designed to examine the impact of agency costs and the consequences thereof, on financial performance. A research methodology that looks into relationships between variables is descriptive design of research. It was therefore employed in this study in obtaining both the general and the specific objectives of the study. The study did a census of the 42 licensed commercial banks in the country. However complete information for all the variables for the five years under study between 2013 and 2017 was obtained for 26 banks only which was a response rate of 61.9%. Data was analyzed by use of SPSS Version 20.0 and various tables, means, percentages, and variations were obtained as output. The output in summary, showed a positive significant relationship between agency costs and financial performance of commercial banks. The finding led to the conclusion that commercial banks in Kenya that make significant investment on issues of directors remuneration and auditors remuneration end up having better financial performance as the agents are motivated to achieve the desired goals by the principals as this would result to achieving their goals as well. Increasing remuneration of the auditor enhances the monitoring of financial issues that compels the management to comply with the needs of the shareholders.
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

According to Jensen & Meckling (1976) agency costs occur as a result of the principal versus agent relationship. The relationship is a legal arrangement between two parties in which one party (principal) appoints the other party (agent) in order to act on its behalf. However, a problem occurs when the interests of the two parties are not aligned which engineers the incurrence of agency costs. We can therefore simply describe agency costs as the internal costs in an organization that are incurred as a result of competing interests between the principals (shareholders) and the agents (management team).

There have been significant changes in the Kenyan financial Sector over the last decade owing to continuous change in regulation, technology and increased competition. There are 42 licensed commercial banks in Kenya with only a total population of about 45 million people, and only about 5% have accounts in these commercial banks. This has caused stiff competition in the banking sector in Kenya, which motivates the banks to exert downward pressure on costs and act as an incentive to enhance efficiency. Every cost that a commercial bank incurs has to be justified in order to maintain and sustain profitability (Miencha & Selvam, 2014).

The intent of this study was basically to look on whether agency costs that arises from the conflicts between the principal and the agent, have any impact on financial performance of commercial banks.
The study appreciated contributions from human behavior studies, in order to comprehend and appreciate the impact of tendencies to control human behavior which may lead to demotivation and therefore poor performance of these banks. Other studies in agency theory and efficient market hypothesis were of significant importance to this study (Klein, 1991).

1.1.1 Agency Costs

The underlying definition of agency costs was proposed by Jensen & Meckling (1976) in their study that observed that the stockholders and bond holders required certain activities to be undertaken, merely from the fact that they had delegated their functions to the managers. These activities they referred to them as agency costs since they were costs that were undertaken to resolve areas where the principal and the agent did not have common interests. It also includes the cost of protecting bondholders from shareholders. The stockholders always bear the burden of incurring agency costs (Jensen & Meckling, 1976).

The main factor that motivates agents to incur agency costs is to ensure that the agents undertake their interests. Williamson (1988) describes agency costs as the total of monitoring expenses by the principal, the bonding expenditures incurred by agent and the residual loss which is generally the loss experienced by a business owner by having his ownership in the business diluted. This forms the major agency cost as the other two are only incurred to the extent that they yield to cost effective reduction in residual loss. These costs are incurred by the supplier of capital in which case debt holders incur them by increasing their interest rates while equity holders incur agency costs by paying for the shares of a company at a cheaper price (Williamson, 1988).
1.1.2 Financial Performance

Financial performance is the degree to which the firms /organization’s policies and operations results are measured in monetary terms. There are various goals that shareholders have. These are preset standards under which a firm would like to achieve after a certain period of time, mostly after a financial year. In order to assess a bank’s financial performance, there are various preset standards that can be looked into. These preset standards are productivity performance, profitability, liquidity, working capital, fixed assets, fund flow and financial performance (Metcalf & Titard, 1976).

This study focused on profitability ratios as the measure of performance. In more specific terms; return on assets (ROA) which is a measure that is frequently used to describe how much profit is generated by each shilling of asset invested in the business. It shows how profitable is the investment that investors make in a bank (Metcalf & Titard, 1976).

1.1.3 Relationship between Agency Cost and Financial Performance.

Shleifer & Vishny (1986) also agree that agency costs are met in order to ensure that the management interests are aligned to the interests of the shareholders. Incentives that are given to the top managers such as share options plans, gives the managers rights to own shares and therefore they act accordingly to ensure that the decisions that they implement is geared towards increasing value of the firm. The agency cost incurred herein by the shareholders is the dilution of ownership, since they have to hive off part of the organization to the management. This therefore indicates that increasing agency costs results to improving financial performance of the organization. Agrawal (1996) however undertook a study that showed that agency costs could be reduced through the presence of large-block shareholders who are also known as the block holders.
They have a commanding stake in an organization which means that they have significant voting rights to be able to influence decisions in the organization. The block holders are able to implement a better monitoring system which improve the market value of the organization. This has also been established by research as conducted by Denis & Sarin (1976) that they are able to outperform their peers.

1.1.4 Commercial Banks in Kenya

Kugiel (2009) defines commercial bank as a financial institution that extends its services to the members of the public and corporate institutions. The services offered by commercial banks include acceptance of deposits, issue both personal and mortgage loans and other financial products that is offered to individuals and corporate organizations. There are other definitions that have been advanced by different individuals. Shweta & Deepika (2008) provides that a commercial bank is described as a financial institution which is in a place to pool resources through the acceptance of deposits from clients. These pooled resources are then issued to capital deficient individuals and business organizations in form of loans so as to earn interests.

Kenya has a population of around 45 million individuals. These individuals are served by a total of 42 commercial banks that are grouped in three tiers depending on their weighted composite index, customer deposits, sizes determined by total net assets, number of deposits and loan accounts and ownership structure. Initially there was a high number of financial institutions in the country that served the population. These institutions included more than 180 Savings and Credit Cooperative Societies (SACCOs), 42 commercial banks and other Micro-Finance Institutions (MFIs).
From the year 2015, the banking sector has experienced a number of turbulent activities that have led to a number of tier 3 banks were placed under receivership after they were assessed to have minimum liquidity ratios. The sector also experienced negative publicity in the social media that led to placing under receivership of banks such as Chase Banks and Imperial banks, though there were suspected fraudulent activities that involved maintaining different books of accounts. This information was leaked to the public through social media, and panic mood engulfed most depositors who flocked the bank to withdraw their deposits. The governor to the central bank placed the bank under receivership in order to protect losses to both the depositors and the investors (Mugambi, 2017).

There are various regulations that are in place that govern the financial institutions in Kenya. Legislation that has been put across include The Companies Act and The Central Bank Act. Other regulations are developed by the CBK as it regulates commercial banks in Kenya. They also find regulations set by Capital Market Authority, CRB among others. The government of Kenya has also introduced interest rate capping through a bill that was passed in parliament and assented by the president. The capping of interest rates has brought quite a number of shake ups in the banking sector with most banks reducing operational costs through laying off staffs, closing branches, use of agency banking among other efforts aimed at reducing total costs. There is a campaign in the banking sector that has been set up in order to entice the law makers to remove capping of interest rates with the notion that such capping of interest rates adversely affects Kenyan economy (Mugambi, 2017).
The robust changes that have been experienced by banks in Kenya, have increased competition and mounted pressure on management to outdo their peers and also outperform their previous records. The government has made the situation worse by capping interest rates and regulations on minimum amount of reserves and liquidity ratio to be maintained by each bank. These conditions are incentives for management to practice earnings management and the shareholders would thus be forced to increase agency costs to ensure that their interests are protected and their wealth is maximized. The study would therefore be impactful in determining whether it would be prudent for shareholders to increase agency costs without jeopardizing financial performance of these banks.

1.2. Research Problem

Jensen & Meckling (1976) asserts that agency costs results from increased conflicts between shareholders and managers. The costs are however incurred by the shareholders so as to ensure that the managers make decisions that will maximize their wealth. However, an increase in costs would mean that operating costs would rise and therefore minimize the total operating profits that would hamper financial performance. On the other end, increase on the agency costs implies that the managers are motivated enough to align their interests with the interests of the shareholders which would lead to increase in financial performance. The question that we therefore tried to answer is; what is the impact of the increase of agency costs on financial performance on commercial banks in Kenya?
The Kenyan banking sector has in the recent past experienced a number of issues that revolve round agency costs. The government has for instance capped interest rates which has consequently reduced financial performance on banks. Several commercial banks have closed down operations in a number of their branches. They have also laid off staff citing increase in operation costs. The capping of interest rates have reduced profitability in the banks and the managements of these banks are under pressure to increase or maintain shareholders earning, and this therefore increases agency costs. CBK has also placed commercial banks such as Imperial Bank and Chase Bank in receivership or under liquidation. These banks were guilty of use of earnings management in order to enhance their records. Accusations that were leveled against some of these banks were maintaining of different sets of books of accounts. These practices increase the principal-agent conflict and we therefore expect the principal to increase their agency costs. The question would therefore be with such increase in agency principal conflicts in the Kenyan banking system, what is the impact on the financial performance of the banks (Cytonn, 2018)?

Local and international studies have been undertaken in this area. Abdulrahman (2012) studied the relationship between agency costs and financial performance for those firms that had been listed at the NSE. The study found a significant positive effect of agency costs on financial performance. Njenga (2012) on the other hand conducted a study to determine effect on financial performance of agency costs for Saccos which had been registered with Fosa in Githunguri District. The results contradicted those by Abdirahman (2012).
Kathenya (2017) looked at agency costs and the portfolio returns of mutual funds in Kenya. He found out that the effect of agency costs on portfolio returns is significant. These local studies show that the results of effects of agency costs on financial performance of different sectors of the economy vary. The results by the local studies on the subject of agency costs and returns by the various organizations including banks, give contradictory results and we may not base on these results to obtain a conclusion on the topic. This creates a study gap in which this study sought out to fill.

In international studies, Acharya et al. (2014) studied agency costs and performance of various banks in India, the results showed that the governance system and hence agency costs in Indian banks were very weak. Wang (2010) investigated the impact of FCF (free cash flow) and agency bank on firm performance in China, where they found evidence supporting agency theory, in that agency costs have a significant but negative effect on firm performance.

Empirical studies therefore give contradicting results to the extent that one may not conclude with accuracy the results of a similar study for banks in Kenya. This therefore creates a research gap, and this study focused on filling the gap by providing possible solutions to the question; what is the impact of agency costs on performance of commercial banks in Kenya?

1.3 Research Objectives

1.3.1 General Objective

The study had a general objective of investigating the impact of agency costs on financial performance of banks in Kenya.
1.3.2 Specific Objectives

The specific objectives identified by the study were;

i. The impact of monitoring costs (audit costs) on financial performance (ROA) of the banks in Kenya.

ii. The impact of residual loss (management incentives) on the financial performance (ROA) of Kenyan banks.

iii. The impact of control variables (size and leverage ratio) on financial performance (ROA) of Kenyan banks.

1.4 Value of the Study

Investors in Kenyan banking sector, would find the study, as it has shed light on the impact of agency costs on returns on assets. The investors would therefore be in position to understand the extent to which agency costs should be incurred in order to optimize their wealth accordingly. The government and other regulatory authorities such as CBK would also find this study helpful. It would help in setting up regulation pertaining the number of directors in banks and the constitution of such directors. Issues on employees share ownership plan would also be adequately regulated to avoid unethical management practices such as hostile take overs among others.

Students and others researchers will also find value from this study. The study will be of use in shaping up the literature review of various researchers in similar line of study. It will also enhance development of theories such as agency theory, efficient market hypothesis, modern portfolio theory among others. This study aims at helping Kenyan Commercial Banks in formulating guidelines and policies to assist in profiling their customers based on the demographic characteristics so as to drop the number loans that
are not performing and to get insight on what it takes to improve their quality of loan book. It will also help the CBK examine various policies implemented to aid supervision of banks as it would emphasize in enabling the banks maintain quality loan books. They would also obtain quality information required in efficient management and supervision of the financial sector. The high incidences non-performing loans are not only a worry to commercial banks but to the regulators and government since high credit non-payment benefits neither the borrower nor the lender.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
The chapter makes an assessment of various theories in line with the topic of the study. Control variables that intervene or moderates the dependent variable are highlighted in the chapter. A number of empirical studies which comprise of both local and international studies are determined from which a conclusion on the existing research gap is brought out. A conceptual framework for the study is described and a general summary of the entire findings of the chapter is also included in the chapter.

2.2 Theoretical Review
There are various theories that are relevant to this study. We shall focus on the contributions made by these theories in order to enhance the concept of agency costs in the modern society. These theories include, agency cost theory, free cash flow theory and stakeholders theory.

2.2.1 Agency Cost Theory
Agency theory is considered to be the oldest theory on management and economics, the first person to suspect the existence of agency theory in organizations is Adam Smith (1937) when he suggested that when an organization is managed by people who are not the owners of the organization then they are less likely to act in an unbiased way that would entirely have principal’s interests at heart. The concept was developed further by contributions from Ross (1973), and Jensen & Meckling (1976).
The theory provides an understanding that aid implementation of various mechanisms for governance that are put in place to control the agent’s actions and inactions thereof. There involves so much contributions by both Jensen & Meckling (1976) on agency cost theory that makes analysts to consider them as the proponents of this theory, though the theory was discovered long before they studied the concept. Despite their contributions and contributions made by other analysts in different fields regarding the same concept of agency costs, so much still remains abstract in regard to the forms of agency cost, their classification, and various factors that affect them. The only underlying concept is that principals or owners of an organization incur costs that help them ensure they compel the management to action in the best interests of the owners of the organization (Caldwell, 2006).

2.2.2 Free Cash Flow Theory

Another aspect that contributes to agency costs was brought to light by Jensen in what was termed as free cash flow theory. Free cash flows theory suggest that managers are only able to pursue the interests of the shareholder and manage their expectations once there is free cash flow available. The free cash flow is obtained after the management has made the necessary investments in working capital as well as the investments in fixed capital. The excess cash flows is however subject to misuse by managers since it represents the excess cash that is available to the organization after the organization makes investments in all projects that have positive NPVs. The increase in free cash flow increases chance that the management may engage in activities that conflict with the shareholders’ interest hence increasing agent – principal conflicts that would consequently increase agency costs (Jensen, 1976).
Jensen (1976) theorised that firms that generate cash in excess of the total cash required to fund positive NPV projects, are at a greater chance to experience management hostile takeover and investments in projects that are value decreasing and therefore exacerbates higher agency costs problems.

2.2.3 Stakeholders’ Theory

Stakeholders’ theory was first proposed by Freeman (1984) where he conceptualized an ideal organizational structure. He observed that organizations were groups of different individuals with different purposes and different needs in the organization. These individuals were referred to as stakeholders. The theory suggested that the purpose of the organization was to meet these different needs of the stakeholders, and manage their interests. Managers are therefore tasked with the responsibility of ensuring that these different needs of the stakeholders are identified, managed and considerably achieved in order to enhance survival of the organization (Friedman & Miles, 2006).

There has been quite a number of contributions on this area by organizations, non-governmental organizations (NGOs), and governments. The contribution are in most cases about the normative principle in which they promote the vision of the organization and the role played by the managers which is to optimize the shareholder value. There is however much literature that is still being contested upon by theorist on stakeholders’ theory that they try to replace and update at the same time (Freeman, 2004).
2.3 Determinants of Bank Performance

A bank’s performance is determined by independent variables. Independent variables are the variables in a study that influences the outcome of the dependent variables. In order for a variable to be truly independent they are assumed that they have very low relationships amongst themselves. The study therefore undertook a multicollinearity test in order to ensure that these variables are truly independent.

2.3.1 Monitoring Costs

These are the costs that are incurred by the shareholders to monitor the managers in order to ensure that their actions maximizes shareholder value. This is because sometimes the manager may want to run an organization in a way that would enhance his/her own goals at the expense of the shareholder, even if it would mean compromising the market value of the organization. The costs of appointing board of directors is considered to a high extent a monitoring cost since they are appointed in an organization to act on behalf of the shareholders by monitoring and restricting activities of the management with the aim of maximizing the shareholder value (Wang, 2010).

Monitoring costs is not only made up of costs of having a board of directors, but rather costs that are associated with preparations of books of accounts and employee stock options plans are all considered to be monitoring costs. Therefore total monitoring costs was obtained from the totals of directors’ remuneration, auditing costs, costs of preparation and making financial statements and the value that the shareholders incur as a result of dilution of their total shares by issuing employee stock options plans (Agrawal, 1996).
2.3.2 Free Cash Flows

Ross (1973) defines free cash flow as the excess of cash that remains after accounting for capital expenditures such as purchase of buildings, equipment among others. The excess cash is then available to the firm to expand their operations by either paying for long term debts, paying dividends, or other purposes of the organization. The free cash flow in an organization depends mostly on the operations of the organization and contributes to the organization’s net income (Ross, 1973).

The data that is used to obtain free cash flow of an organization is mostly found on the organization’s cash flow statement. FCF is therefore obtained from total cash flow from operations less cash flow spent on capital expenditure. High FCF indicates that the organization has cash to expand its operations, develop new products, pay dividends or reduce debts. It also however implies that the management is not lucrative enough to find investment projects that would yield positive NPVs. The presence of high FCF also increases the chance of management to make decisions that would not necessarily maximize shareholder value, and therefore the shareholder is forced to incur extra agency cost to protect his interests (Acharya, et. al. 2014).

2.3.3 Firm Specific Factors

These are factors that are specific in nature to the organization and they affect the performance of the banks. These factors include, firm size, age and capital structure. They are specific to the firm since each bank has different size, age and capital structure as compared to another. The size of a bank is determined by its total assets, large banks have the ability to offer better services since they enjoy the economies of scale and they can afford to give discounts that increases their total revenue and improves performance.
On the other hand age of a bank shows how long the bank has built its brand and gained a better understanding of the market that helps it in market positioning. It is therefore considered that older banks have better performance than younger banks. Capital structure is the debt equity ratio of a bank. According to Modigliani and Miller (MM) a firm that has higher debts has a higher value than a firm with no debt, it therefore shows that the capital structure also in a certain extent affects the performance of a bank (Baker & Powell, 2010).

2.4 Empirical Studies

Empirical studies that have previously been conducted by either local or international researchers on agency costs and influence of agency costs to either financial performance or other organizational performance measures. The existing empirical evidence denotes that there are both consistent and conflicting findings from various studies. This is an indication that researches conducted in this area are not conclusive enough to have a common stand that is agreeable to all studies. In this section we summarise some of these local and international studies, from which we shall then draw conclusions.

A study that is almost similar to this study was conducted by Abdulrahman (2014) who looked into the relationships between agency costs and financial performance of firms listed at NSE. He conducted a descriptive study for all the companies listed at the NSE within the period of 5 years (2008-2012), in which he used secondary data to collect data for analysis. He then conducted a multiple regression analysis and correlation analysis to determine the effect of independent variables on the dependent variable. The study showed that there was a positive significant effect of agency costs on financial performance.
Ochieng (2013) on the other hand undertook to seek the impact of corporate governance on the dependent variable of agency cost for the various firms listed at NSE. It had been theorized that improving the mechanisms for corporate governance reduced agency costs incurred by a firm. The study therefore concentrated on ensuring whether it supported this theory or deviated from it. He randomly selected a sample of 34 listed firms and collected their data for ten years (2003-2012), panel data estimation technique was used to analyse this data. The results showed significant and random effects on the data. Individual effects such as age and gender had significance correlation to at least one of the regressor variables in the model. Other corporate governance mechanism that included having a strong audit committee in the board, and non-executive directors significantly reduced agency costs in the firm. Firm size and leverage had positive correlation with agency costs in the firm. The study however failed to find a significant influence of corporate governance variables such as presence of nomination committee, institutional ownership or board ownership.

A study was also conducted on agency banking and its effect on operational performance of various commercial banks in Kenya by Gitau (2014), she concentrated on the agency banking and how it influences the performance of commercial banks. The study conducted a descriptive research design survey study and data collected via questionnaires was analysed by the use of SPSS statistical tool. The study showed that liquidity availability negatively affected banks performance. Agency infrastructure costs and security issues also significantly influenced banks’ performance.
Asuke (2009) investigated the effect of dividend policy of the firms at NSE on agency costs. Secondary data collection method was employed to collect data for the variables for the period 1999 – 2008 from published financial accounts. It then used linear regression model to look at the effect of independent variables on dependent variables. The study established that firms listed at the NSE use a dividend policy of paying a constant amount per share but also adjusted dividend payments in regard to performance, agency costs for small firms was considered to be high while no significant relationship that was established between the agency costs and the dividend policy.

A study that investigated the effect of agency costs on ownership structure by Ang, et al. (2002) used absolute measures of relative equity and compared it with agency costs for various corporations with different ownership, management and capital structures. They used the Jensen & Meckling’s (1976) case as their base case where they utilized a sample of 1,708 SMEs. The study considered agency costs to increase when an outsider was in charge as compared to the time when an insider was in charge of the firm. They also found that agency costs decreased significantly with greater monitoring by banks.

Berger & Bonaccorsi (2006) found a new approach to test agency theory more importantly in the banking industry by studying capital structure and firm performance. The existing theory suggested that leverage increases agency cost and hence negatively affects firm performance. The study therefore devised a new approach to undertake the study. Performance was measured by the use of profit efficiency where every firm’s performance was benchmarked to the best performing firm that experienced the same exogenous conditions. They employed a simultaneous equations model that was used to account for reverse causality from performance to capital structure.
The study found out that indeed leverage increased agency costs that adversely affected financial performance of US banks. The results were not only consistent with the theory, but they were also statistically significant, economically significant and robust.

Locke (2014) on the other hand studied agency costs and the performance of banks in India. He used both empirical and quantitative analysis where he utilised secondary data that was obtained from Reserve Bank of India. The results indicated that there are distinguishable differences in agency costs across banks in India, and across categories of banks. The findings also suggested that there was weak governance in banks owned by government that increased agency costs significantly.

2.5 Conceptual Framework

The conceptual framework presents a pictorial view that points to the resulting relationship between the variables. The dependent variable is the financial performance which is influenced by the independent variables namely; agency costs (monitoring costs and residual loss) and firm specific characteristics (Size, Age and capital structure). The conceptual framework is as shown in the figure 2.1.
2.6 Summary and Conclusions

The study therefore sought to either agree or disagree with the following theories, agency cost theory, free cash flow theory and stakeholder’s theory. The study will also be useful to other theories such as efficient market hypothesis theory, modern portfolio theory among other theories.

The conceptual framework diagram helped us to identify the relationship between variables and appreciated the contributions that were made from the results of the study. Empirical review also enabled us to identify the area that was under the study and appreciated the controversy that surrounds the concept of agency costs. Some local studies have given us consistent results that agree with proponents of the theory while others contradict the theory and therefore contradicts each other.
Ochieng (2013) found out that firm size has a direct relationship with agency cost while on the other hand Asuke (2009) had found agency costs for the small firms to be higher than that of big firms.

The same controversy exists in international studies and this gave us the research gap in that there are no conclusive studies undertaken to prove either the relationship or the impact of the relationship between agency costs and financial performance. The study is therefore very useful in highlighting the effects of increasing or reducing agency costs on the financial performance. It will therefore help policy makers, local and international investors while at the same time, it will contribute significantly to the existing literature.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
The chapter on research methodology describes the research design used and highlights population of the study and whether there was need to undertake sampling. The methods employed in data collection and analysis of the data are also considered in the chapter. It also contains diagnostic tests that were undertaken in the study.

3.2 Research Design
Research design can be described to mean the approach that is used in a research so as to effectively conduct the study. It involved working on data collected by the use of statistical tools so as to achieve a plausible outcome. Every study should have a strategic research design that follows a strategic methodology which is in line with the type of research to be undertaken in order to obtain authentic and accurate results (Kothari, 2004).

There are four types of research design; exploratory research design that explores or finds out something by answering the question in ‘what’ or ‘how’ manner. Descriptive research design is more in depth than exploratory and answers the fundamental questions of what and how. Explanatory research design on the other hand seeks to explain the subject matter being researched and answers the fundamental questions of what, how and why. Evaluation research is another research design that measures the effectiveness of a research program, this type is considered most extensive (Kothari, 2004).
The study used a descriptive research design as it has the capability of shedding more light on relationships.

3.4 Target Population

The population of the study composed of all possible set of information or data that existed, which were of interest to the study. All commercial banks that had secured operating licenses for the year 2017 composed the entire population of the study. There was a total of 42 licensed commercial banks in the year 2017 which were grouped into different tiers depending on their sizes. The study focused on all the commercial banks in all the different tiers. The study conducted a census of all banks and therefore no sampling was required.

3.5 Data Collection Methods

The study used secondary data to perform quantitative analysis on audited financial data that was available on each commercial bank’s financial statements and financial reports held by regulating bodies such as CBK for the period 2013-2017, a period of five years.

3.6 Data Analysis

SPSS version 20.0 software was used to undertake analysis of the study. It was then presented in tabular form and figures for discussion and analysis.

3.6.1 Analytical Model

The study used a multiple regression model to estimate a linear regression between financial performance and agency costs incurred by licensed commercial banks.
The following regression equation was used;

\[ Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon \]

Where

\( Y = \) Financial performance & measured by Return on Assets (ROA)

\( X_1 = \) Agency Costs measured by the sum of directors remuneration and auditors remuneration in a bank

\( X_2 = \) Size as measured by total assets of a bank.

\( X_3 = \) Leverage; measured by debt to equity ratio

\( \varepsilon = \) Error term

\( \alpha = \) Constant

\( \beta_1, \beta_2, \beta_3, \) are coefficients of independent variables \( X_1, X_2, \) and \( X_3 \) respectively.

### 3.7 Diagnostic Tests

Diagnostic tests was used in the study in order to increase accuracy on the results obtained. The tests were used to make diagnosis that helped to understand the probability that the study gave accurate results.

#### 3.7.1 Test for Linearity

Test of linearity was conducted on the data collected so as to ensure analysis was done on data closest to the line of best fit. Coefficient of determination \( R^2 \) was used to conduct this test.
3.7.2 Test for Multicollinearity

According to Kothari (2004) multicollinearity is a problem that needs to be addressed in every research study in order to obtain accurate results. Multicollinearity is a phenomena where a predictor variable highly correlates with another predictor variable in a redundant way that does not add value to the entire model. The model is therefore left exposed to erratic changes that result from minor changes in the variables or in the model that makes it difficult to establish the individual contribution of a single variable to the entire model.

3.7.3 Test for Autocorrelation

Durbin Watson test is in most cases used to detect the presence of autocorrelation in the data. Autocorrelation mostly occurs in time series data. This study also used Watson test to test for autocorrelation in the data.
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction
This chapter analyses data by describing data collected for all the variables. A response rate was determined and a regression analysis undertaken in order to determine the linear relationship between the variables. F test statistic was undertaken to determine model’s significance and whether to reject the null hypothesis or fail to reject the null hypothesis. The results obtained are discussed appropriately.

4.2 Response Rate
The population comprised of all 42 commercial banks licensed in the country as at the year 2018. Data was collected from the financial reports for the years, 2013-2017. However complete information for all the variables for the five years was obtained from only 26 banks. This was a response rate of 61.9%. Mugenda & Mugenda (2013) suggest that a response rate of over 60% is considered appropriate for data analysis.

4.3 Descriptive Statistics
The dependent variable, return on assets was measured by the percentage of net income after tax over total assets of the bank. In the entire period under study, the bank that recorded the highest return on assets had 42.37% while the least recorded was a loss of -132.77%. The mean was at 7% with standard deviation at 18%. This shows that the performance of commercial banks is not uniform, it varies from one bank to the other and from one year to the other. Data is negatively skewed with a high kurtosis of 28.37.
The other variable is Agency cost. It was measured by the sum of audit cost and director’s remuneration. The highest value recorded was 6.09 and the least was -.69 with a mean of 3.68 and a standard deviation of 1.29. Distribution of this data is also negatively skewed with a relatively flatter kurtosis of .95.

The study used capital structure and size as control variables. The capital structure was defined by the debt equity ratio. The minimum of this ratio was zero, meaning that some commercial banks did not have any outstanding debt and all their operations were financed through equity. The maximum ratio was 0.403 that showed that the debt level was 40.3% while the rest was financed through equity. The mean was 0.075 with a standard deviation of 0.087 with a positive skewness with a sharp kurtosis of 4.25.

Size was used also as a control variable. It was measured by looking at the total assets of the commercial banks. The minimum was 6.9 and the maximum was 13.38 with a mean of 9.17. The standard deviation was 1.56 with a positive skewness and a relatively flat kurtosis of -.193.
4.4 Correlation Analysis

Pearson correlation analyses the linear relationship between the variables. Two variables have a stronger relationship if the value of the Pearson’s correlation is one or close to one, whether positive or negative. Variables that have a Pearson Correlation value of zero or close to zero have no relationship or else they have weak relationship. Table 4.2 describes the relationship between the variables.

Table 4.2: Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>Y = R OA</th>
<th>X1 = Agency Cost</th>
<th>X2 = Debt/Equity Ratio</th>
<th>X3 = Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y = R OA</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X1 = Agency Cost</td>
<td>0.12295894</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>X2 = Debt/Equity Ratio</td>
<td>-0.100140649</td>
<td>0.393039243</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>X3 = Size</td>
<td>0.391844839</td>
<td>0.626999457</td>
<td>0.390005804</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Author 2018

We are interested in the Pearson correlation between the dependent variable and the independent variables. The values are all close to zero showing weak correlation between the variables. The strongest relationship is between Size and financial performance with a Pearson’s value of 0.39. The relationship is positive meaning the bigger the bank the higher the financial performance. Agency cost has a weak but positive relationship with financial performance. This means that increasing agency costs increases financial performance in the commercial banks though the relationship is not as strong. Capital structure relationship has a negative relationship with the dependent variable. When debt is increased relative to equity financing, the financial performance is reduced. Size on the other hand has a positive relatively stronger relationship with financial performance. This
means the larger a commercial bank is, the better is its financial performance. This can be explained by the fact that large commercial banks have established their brand names, they enjoy economies of scale and they have consolidated trust in their clients and created loyalty that enables them enjoy favourable financial performance.

4.5 Regression and Hypothesis Testing

In order to determine the relationship that exists between agency cost and financial performance, a multiple linear regression model represented by \( Y = \alpha + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon \). The results determines the strength of the model in predicting the dependent variable, the significance and the nature of the relationship.

4.5.1 Regression Summary

A regression model summary, shown in the table 4.3 helps to summarize key concepts of the regression.

**Table 4.3: Regression Model**

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>R Std. Error of the Estimate</th>
<th>Durbin-Watson</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.489(^a)</td>
<td>.240</td>
<td>.221</td>
<td>15.8807253</td>
<td>1.665</td>
</tr>
</tbody>
</table>

Source: Author, 2018

The regression model summary shows a coefficient of determination (R\(^2\)) value of 0.24. This suggests that the model can be able to predict 24% of the changes in financial performance. This can be cleared to mean that 24% of the changes in financial performance of commercial banks can be attributed to changes in agency cost and size of the commercial bank.
Durbin Watson value on the other hand measures the level of autocorrelations in the model. The autocorrelations are model errors that determine whether there exists autocorrelation between the variables. Durbin Watson suggested that a value of 1 to 4 is considered appropriate, while a value that is above 4 shows that the model has enough autocorrelation to impact error in the model. The value of Durbin Watson in this case is 1.67 which is within the acceptable levels for autocorrelations.

4.5.2 One Way ANOVA

The ANOVA table measures the significance and also guides on whether to reject the null hypothesis or fail to reject the same.

**Table 4.4 Anova Table**

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>10012.772</td>
<td>3</td>
<td>3337.591</td>
<td>13.234</td>
<td>.000*</td>
</tr>
<tr>
<td>Residual</td>
<td>31776.877</td>
<td>126</td>
<td>252.197</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>41789.649</td>
<td>129</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Author, 2018

The regression analysis was undertaken at 95 degrees of freedom which shows that the alpha value was 0.05. The alpha value is compared with the p value in which case we determine the significance of the model. If the alpha value is greater than the p value, then the model is said to be significant and the vice versa is true. In the table 4.4 the p value is 0.000 while the alpha value is 0.05. Alpha value is greater than the p value and we therefore conclude that the model is significant.
The null hypothesis which states that there exist no impact of agency cost on financial performance. The analysis should provide enough evidence for us to either reject or fail to reject the null hypothesis. In order to reject the null hypothesis the F critical value that is found by looking at the F distribution table at an alpha value of 0.05 and degrees of freedom 3 and 126, should be less than the F calculated value. The F value would therefore lie within the rejection area. The F critical value is 2.6 while the F calculated according to table 4.4 is 13.23. It is therefore clear that the F calculated value is greater than the F critical value and therefore the F calculated value falls under the reject area. The study therefore rejects the null hypothesis and concludes that there exists a significant relationship between agency costs and financial performance. According to correlation analysis, the relationship is positive that means that an increase in agency costs increases financial performance of banks.

4.5.3 Regression Coefficients

The coefficients for the regression model \( Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon \) and the constants are shown in table 4.5 below.

Table 4.5: Regression Coefficient Table

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
<th>95.0% Confidence Interval for B</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>-43.714</td>
<td>8.703</td>
<td>-5.023</td>
<td>.000</td>
<td>-60.937 to -26.490</td>
<td></td>
</tr>
<tr>
<td>X1 = Agency Cost</td>
<td>-1.889</td>
<td>1.426</td>
<td>-.135</td>
<td>.188</td>
<td>-4.712 to .933</td>
<td>.581 (1.722)</td>
</tr>
<tr>
<td>X2 = Debt/Equity</td>
<td>-56.988</td>
<td>17.890</td>
<td>-.275</td>
<td>.022</td>
<td>-92.391 to -21.584</td>
<td>.812 (1.232)</td>
</tr>
<tr>
<td>X3 = Size</td>
<td>6.748</td>
<td>1.177</td>
<td>.584</td>
<td>.000</td>
<td>4.419 to 9.077</td>
<td>.582 (1.717)</td>
</tr>
</tbody>
</table>

Source: Author, 2018
The coefficients $\beta_1$, $\beta_2$ and $\beta_3$ are given by -1.89, -56.99 and 6.75 respectively. The constants $\alpha$ and $\varepsilon$ are given by -43.71 and 8.7 respectively. The regression model therefore becomes

$$Y = -43.71 - 1.89 X_1 - 56.99 X_2 + 6.75 X_3 + 8.7$$

4.6 Discussion of Research Findings

The study found that there was positive significant impact of the independent variables on the dependent variable. The regression model was found to be relatively weak as it only predicted 24% of the financial performance. The other 74% was predicted by other factors outside the model. The correlation analysis showed a positive relationship between agency cost and financial performance of these banks. This means that increasing agency costs would result to an increase in financial performance.

The p value was 0.000 which was less than alpha value of 0.05, which showed that the impact was significant. In order to determine whether to reject the null hypothesis or fail to reject the null hypothesis, F statistical is compared against F calculated. The $F$ calculated was greater than $F$ critical which showed that we reject the null hypothesis and therefore conclude that there exist a relationship between agency cost and financial performance.

A local study that was undertaken by Gitau (2014) and another by Abdulrahman (2014) were all in agreement with the results of this study. They all found that there existed a positive significant relationship between agency cost and financial performance. The results are also consistent with the provision of agency cost theory where the principals are required to undertake significant costs in order to recognize positive performance that
is consistent with their wants. The study was however found to contradict the results by other studies. A study that was conducted by Berger & Bonaccorsi (2006) found out that increase in agency costs affected leverage which ultimately negatively affected financial performance. This study therefore contradicts the findings of such studies while it agrees with the findings by other researches.

The findings of the research suggests that shareholders would need to undertake agency cost that would compel the agents to act in the interests of the shareholders so as to achieve a better financial performance in these banks. When directors’ remuneration is pegged to the performance of the bank, then directors are able to enhance and sustain increased financial performance as doing so furthers their interests as well. The study also suggest that when a commercial bank increases its auditor’s remuneration, then the auditor is able to conduct conclusive audit and therefore reveals all bottlenecks that would eat up financial performance of the commercial banks.
CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
These chapter looks at the summary of the research findings, conclusions that is arrived by the study and also the recommendations made. It also clarifies on the limitations of the study as it suggests on areas that would need further research.

5.2 Summary of Research Findings
According to the findings of this study, there is a significant positive relationship between agency costs and financial performance. Increase of investments in agency costs increases the financial performance of commercial bank. The agency cost is measured by both directors’ remuneration and auditor’s remuneration. This therefore means that increasing the expenses of these expenses leads to an increase in financial performance.

The financial performance of commercial banks, were also found out to vary from one bank to the other. The variation in the performance was highly based on the size of different banks. It therefore suggested that large banks were able to command a high trust and loyalty in most clients as they continued making deposits, and borrowing loans from such banks. Small banks on the other hand had difficulty with maintaining their clients as they struggled with sustaining high performance. This could be attributed to trust issues with small banks as could be clearly seen through banks such as Imperial and Chase banks that were placed in liquidation by the governor of the Central Bank, as a result of panic that led depositors to rush in large numbers and withdraw their funds as damaging information regarding practice of earning management by the directors of the bank was
leaked to the public. It was also found out that some banks had a capital structure that was made up of entirely equity as they had zero long term debts. The correlation between capital structure and financial performance was negative as it was -0.1 which showed a negative though a weak correlation with financial performance. This suggests that increase in debt financing would lead to a decrease in financial performance though the relationship is not strong enough. Many commercial banks therefore resulted in reducing their borrowings and concentrated on financing most of their operations through equity. This would also be due to the stipulation by the regulator, where a certain capital adequacy ratio has to be maintained by each commercial bank in Kenya.

5.3 Conclusions

The study makes various conclusions based on the findings of the study. The finding that there exists a strong positive relationship between commercial banks and financial performance leads to the conclusion that the banks in Kenya that make significant investment on issues of director’s remuneration and auditors’ remuneration, end up having better financial performance as the agents are motivated to achieve the desired goals by the principals as it would result to achieving their desired goals as well. Increasing remuneration of the auditor enhances the monitoring of financial issues that compels the management to comply with the needs of the shareholders.

The study also concludes that large banks have better financial performance than small banks. This has been attributed to both economies of scale that big banks enjoy as well as the trust elements that help the big banks both retain and attract new customers. Clients become very suspicious of small banks, when negative information regarding engaging in earnings management by the directors leaks to the public.
The small banks are therefore forced to give enticing offers that would compel clients to stick to them rather than going to the large banks which eats up to their profitability. The study also shows that the financial performance of the highly leveraged firms is less than the performance of the low leveraged firms. The negative financial performance of highly geared commercial banks may be explained by the cost of borrowing funds in Kenya might be expensive that would surpass the gain achieved by the tax shield enjoyed by geared firms, or the sense that commercial banks are highly regulated by Central Bank of Kenya. There is a minimum capital adequacy ratio that needs to be maintained by each bank, failure to which would result in fines and penalties that would eat up the profits.

5.4 Recommendations

From the conclusions made, there are various recommendations that would be made by the study. The study recommends that remuneration of the directors should be pegged to the performance of the commercial bank. This could be in form of performance bonuses or through share ownership that means that the directors would be more willing to act in the interests of the shareholders as both their interests and those of the shareholders are aligned.

The auditors should be well remunerated and scope of the work to be undertaken increased so as to give an in depth audit. The in depth audit would reveal errors, omissions and possibly fraud that would be dealt with accordingly. This kind of monitoring would put more pressure on the directors to ensure that they comply with the interests of the shareholders since otherwise they would have to face the repercussions of failure to comply with the shareholders’ needs.
The study also recommends that small commercial banks should either merge with others to make big banks or they would be forced out of business. When the attractive super normal profits that are made by the commercial banks in Kenya are exhausted, the small banks would find it difficult to convince clients to stick to them as they would not be in position to offer discounts to their clients beyond the market prices. It would therefore mean that they would be forced out of business.

The regulations on capital adequacy should either be reviewed or implemented in such a manner that it would not affect the financial performance of commercial banks. The review of the capital adequacy would ensure that commercial banks could still obtain long term financing from other sources that they would use for financing their operations of either advancing loans or making investments in projects that have positive NPVs.

5.5 Study Limitations

The study experiences several limitations. First the study relied on data that was obtained from the financial statements of 26 banks that had all the information required in their websites. Due diligence in capturing the data was exercised, however, the authenticity of this data could not be guaranteed that it was free from errors or any other form of bias. The study did not verify the data with other similar data stored with the regulatory body (CBK) or obtained any other authentication from the commercial bank.

The conclusions was made from the study of 26 commercial banks out of a possible 42 licensed commercial banks. The other commercial banks did not have all the required data for the all the years required. The generalization of all commercial banks does not mean that all the 42 commercial banks were studied. The generalization was based on the
principal stated by Mugenda & Mugenda (2013) that a response rate over 60% is considered appropriate for data analysis and conclusion.

5.6 Suggestions for Further Research

The study suggests that further research be undertaken including other form of agency cost such as share ownership plan offered to the shareholders. This comprehensively includes all the three types of agency costs and would therefore have conclusive results on the effect of agency cost on financial performance in commercial banks in Kenya. Further studies would also be necessary if the scope of the study was undertaken in another African nations such as Tanzania, Rwanda, etc in order to undertake comparative study on effects of agency costs on financial performance for various African countries.
REFERENCES


APPENDICES

Appendix 1: List of Licensed Banks

1. Abc Bank Kenya
2. BOA
3. BOI - Bank of India
4. Barclays
5. Chase (in Receivership)
6. Citi Bank
7. CBA - Commercial Bank of Kenya
8. Consolidated
9. Coop Bank
10. Credit Bank
11. DBK – Devt Bank
12. DTB
13. Dubai Bank
14. Ecobank
15. Equity Bank
16. Family Bank
17. First Community Bank
18. GT Bankk
19. Gulf Bank
20. Habib A.G. Zurich
21. Housing Finance
22. I & M
23. Imperial (In Receivership)
24. Jamii Bora
25. KCB
26. Mayfair Bank
27. Middle East Bank
28. National
29. Bank
30. NIC Bank
31. Oriental Commercial Bank
32. Paramount
33. Prime Bank
34. SBM Kenya
35. Sidian Bank
36. Spire Bank
37. Stanbic Bank
38. Standard Chartered
39. Transnational bank
40. Transnational Bank
41. United Bank for Africa
42. Victoria Commercial Bank
## Appendix II: Table of Data used in Analysis

<table>
<thead>
<tr>
<th>Y = R OA</th>
<th>X1 = Agency Cost</th>
<th>X2 = Debt/Equity Ratio</th>
<th>X3 = Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>32.92392</td>
<td>5.003946</td>
<td>0.121853</td>
<td>10.68185</td>
</tr>
<tr>
<td>3.939191</td>
<td>4.782479</td>
<td>0.280232</td>
<td>12.3511</td>
</tr>
<tr>
<td>4.487788</td>
<td>4.343805</td>
<td>0.01793</td>
<td>9.356789</td>
</tr>
<tr>
<td>23.23866</td>
<td>5.164786</td>
<td>0.00893</td>
<td>10.59303</td>
</tr>
<tr>
<td>4.376879</td>
<td>3.989894</td>
<td>0.338095</td>
<td>8.691779</td>
</tr>
<tr>
<td>24.54673</td>
<td>4.812184</td>
<td>0.107504</td>
<td>10.8342</td>
</tr>
<tr>
<td>22.70536</td>
<td>3.989894</td>
<td>0.061554</td>
<td>9.949942</td>
</tr>
<tr>
<td>19.26304</td>
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<td>0.024161</td>
<td>10.58578</td>
</tr>
<tr>
<td>8.485792</td>
<td>4.110874</td>
<td>0.074838</td>
<td>7.851272</td>
</tr>
<tr>
<td>11.70652</td>
<td>4.269697</td>
<td>0.018928</td>
<td>9.817875</td>
</tr>
<tr>
<td>-17.44144</td>
<td>3.555348</td>
<td>0.131836</td>
<td>7.279319</td>
</tr>
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<td>23.77507</td>
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<td>7.72018</td>
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<td>6.896694</td>
</tr>
<tr>
<td>14.21908</td>
<td>3.621671</td>
<td>0.03281</td>
<td>10.49116</td>
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<td>0.079469</td>
<td>7.546974</td>
</tr>
<tr>
<td>4.382716</td>
<td>1.916923</td>
<td>0.018855</td>
<td>7.284821</td>
</tr>
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<td>14.16767</td>
<td>1.987874</td>
<td>0.010345</td>
<td>7.413367</td>
</tr>
<tr>
<td>4.203947</td>
<td>1.856298</td>
<td>0.053135</td>
<td>7.326466</td>
</tr>
<tr>
<td>12.66999</td>
<td>2.028148</td>
<td>0.009689</td>
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</tr>
<tr>
<td>1.674419</td>
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<td>0.087228</td>
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<td>15.65332</td>
<td>5.147494</td>
<td>0.046754</td>
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<td>26.95204</td>
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