THE EFFECTS OF BOARD DIVERSITY ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

This project is my original work and has not been presented in any other institution of learning for any academic award.

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DEDICATION

This project is sincerely dedicated to my loving wife Elizabeth and our Daughter Mary for accepting me to spend most of their time out of the normal outing schedules to offering the same to library and my parents for the unquantifiable support they also offered. I could not have completed this research proposal without constant encouragement from my colleagues and friends even if time may not allow me to mention you by names.

May the Lord God bless you all.
ABSTRACT

This study examined the relationship between Board diversity and financial performance of commercial banks registered and domiciled in Kenya. Data on Boards’ gender, educational qualifications, study specialization, and board specialization as well as the companies’ financial performance were obtained from the central Bank of Kenya supervisory department where a total of 33 banks reports was attained.

This study used descriptive and explanatory designs that involved gathering data that described the events and then organized, tabulated, depicted and described the data collected. Only secondary data was used.

Using the Ordinary Least Squares (OLS) regression, the results show that there is very minimal association between board diversity and financial performance.

The results partially concurred with agency and resource dependency theories of corporate governance as well as similar empirical studies. Ensuing implications for theory, policy and practice as well as methodology were also discussed.
LIST OF ABBREVIATIONS

CBK ……… Central Bank of Kenya
CEO ……… Chief Executive Officer
EOWA ……. Equal opportunity for women in the workplace Agency
EPWN ……. European professional women’s network
EU …………. European Union
NSE ……… Nairobi Securities Exchange
OECD ……. Organization for Economic co-operation and Development
OLS ………… Ordinary Least Squares
ROA ……….. Return on Assets
ROE …………. Return on Equity
UK …………. United Kingdom
USA ……… United States of America
Table of Contents

Declaration .................................................................................. i
Acknowledgements ........................................................................ ii
Dedication ..................................................................................... iii
Abstract ....................................................................................... iv
List of Abbreviations ....................................................................... v
List of Tables ................................................................................ viii
Chapter One: Introduction .............................................................. 1
1.1 Background of the Study .......................................................... 1
1.1.1 Board Diversity ................................................................. 2
1.1.2 The Board and Firm’s financial performance ......................... 3
1.1.3 Commercial Banks in Kenya ............................................... 4
1.2 Problem Statement .................................................................. 4
1.3 Objectives of the Study ........................................................... 5
1.4 Value of the Study ................................................................... 6
Chapter Two: Literature Review ...................................................... 7
2.1 Introduction .............................................................................. 7
2.2 Theories of Board Diversity .................................................... 8
2.2.1 Agency Theory ................................................................. 9
2.2.2 Stakeholder theory .......................................................... 10
2.2.3 Resource dependency theory ............................................. 11
2.3 Measures of variables ........................................................... 12
2.3.1 Employee status ............................................................ 12
2.3.2 Occupational or professional attributes ............................. 12
2.3.3 Personal attributes ......................................................... 13
2.4 Empirical Literature ................................................................. 13
2.5 Summary of Literature review .......................................................17

CHAPTER THREE: METHODOLOGY ................................................. 19
3.1 Introduction .............................................................................. 19
3.2 Research design .......................................................................19
3.3 Population and sampling ...........................................................19
3.4 Data collection and description ...................................................19
3.5 Data analysis and technique ........................................................20

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSIONS.......... 22
4.1 Introduction .............................................................................. 22
4.2 Experience Diversity ............................................................... 22
4.3 Gender Diversity ..................................................................... 24
4.4 Profession Diversity ................................................................. 27

CHAPTER FIV: SUMMARY, CONCLUSION AND RECOMMENDATIONS...... 29
5.1 Introduction .............................................................................. 29
5. Summary ..................................................................................... 29
5.3 Conclusions .............................................................................29
5.4 Limitations ...............................................................................30
5.5 Suggestions for further research ...............................................31

References.........................................................................................32

Appendices

Appendix I: List of Commercial Banks in Kenya .................................... 38
LIST OF TABLES

Table 4.1 Test statistics on experience factor of diversity .......................... 22
Table 4.2 Results on experience factor on the return on assets ...................... 23
Table 4.3 Test statistics on gender as factor of diversity ............................. 25
Table 4.4 Results on gender factor to the return on assets ........................... 26
Table 4.5 Test statistics on profession factor of diversity ............................. 27
Table 4.6 Results on profession factor to the return on assets ........................ 28
CHAPTER ONE: INTRODUCTION

1.1 Background of the study

Does the diversity of the board of directors affect a company’s performance? This question lies at the heart of much research in corporate governance. Charged with hiring, evaluating, compensating, and on-going monitoring of management, the board of directors is shareholders’ primary mechanism for oversight of managers. Recently, researchers have started investigating the effect of board diversity which is described as the variation among its members (Coffey & Wang 1998). Despite considerable research into how boards are structured and their impact on various corporate decisions, there is no clear consensus on whether board diversity affects corporate performance. Studies on the impact of board diversity can be broadly divided into two categories: those that consider the board’s influence on a specific corporate decision and those that study the effect of board structure on measures of overall firm performance.

The issue of corporate governance has become obverse and centre of the agenda for both business leaders and regulators all over the world following the global financial crisis. The crisis has provided many illustrations of the collapse of corporate governance and, consequently, international regulators are hard at work to influence appropriate regulatory controls. Thus, the role of effective corporate governance is of massive importance for the society as whole. First, it encourages the efficient use of scarce resources within the organization and the economy. Second, it makes the resources flow to the most efficient sectors or entities. Third, it helps the managers to remain focused on improving performance. Fourth, it provides a tool of choosing the best executive to control the scarce resources. Finally, it forces the organization to comply with the rules, regulations and prospects of society.

Corporate governance issues related to banks have been ignored by prior research. Therefore, the Basel Committee on Banking Supervision has called attentiveness to the need to study and improve the corporate governance of the financial institutions. The Committee especially advocates a governance structure composed of a board of directors and senior management. Furthermore, the Committee believes that corporate governance is necessary to guarantee a
sound monetary system and, therefore, a country’s economic development. While, most of the empirical studies on corporate governance focused on firms in the non-financial sector (Handley-Schachler et al. 2001, Adams and Mehran, 2003 & 2008), there are some papers concentrated on banks’ corporate governance (e.g. Macey and O’Hara, 2003; Levine, 2004; Larcker et al., 2007; Caprio et al., 2007).

1.1.1 Board Diversity

Management scholars with backgrounds in sociology and social psychology were among the first to conduct statistical studies of board composition. Pfeffer (1972) can be credited as the pioneer of this field. Pfeffer views boards mainly as a mechanism for co-opting other external organizations and individuals, which is consistent with his view of firms as dependent on external resources. He hypothesizes that board composition in terms of insiders and outsiders, the number of directors with financial expertise, and the number of lawyers on boards depends on the firm’s need for creating links with the external environment (for example, the need to deal with regulators and banks).

Women hold few corporate board seats. In the United States, women held 15.2 percent of Fortune 500 board seats in 2008 (Catalyst 2009). The percentage of female directors in Japan, Europe, Australia, and Canada is estimated to be 0.4 percent, 8.0 percent, 8.7 percent, and 10.6 percent, respectively (Equal Opportunity for Women in the Workplace Agency [EOWA] 2006; European Professional Women’s Network [EPWN] 2004).

This relative underrepresentation of women in the boardroom has not gone unnoticed. Catalyst, a nonprofit organization committed to promote women in business, has been publishing a census of women in Fortune 1000 boards since 1993. The Higgs report (Higgs, 2003) and the Tyson report (Tyson, 2003) call for increased representation of women on British boards. In some countries, legislative initiatives to promote women on boards are gaining momentum.

In Kenya, corporate boards including those of commercial banks are said to be male dominated since the appointments are done in an old boy network (Business Daily, 2010). Old boy network is whereby the male directors introduce their friends to boards before they retire. The Institute of
Directors of Kenya decries that this appointment process denies majority of the women the chance to be selected to the corporate boards hence depriving the organization this important resource. This therefore means the effect of a diverse board on firm value as pointed out by Carter et al. (2003), Hambrick et al. (1996), Bohren & Strom (2007) etc. may not be felt in the Kenyan context. However, this situation may not last especially with the passing of the new constitution which requires female participation in almost all spheres of life.

1.1.2 The Board and Firm’s Financial Performance

When the boards make good decisions, companies prosper, and when companies prosper, the nation prospers. Who the directors are, what boards of directors do and how well they do it are important issues, not only for all shareholders, but for everyone dependent upon a vigorous economy for their well-being, which is to say, everyone (Leblanc & Gillies, 2005: 50–51)

Directors who truly want to build an effective board need to look far beyond any externally imposed rules and procedures. The starting point is taking an honest look at how and how well they work with one another (Carter & Lorsch, 2004: 164)

Although it has been extensively researched, how corporate boards influence their firms’ financial performance remains a puzzle. Boards, occupying “the very uppermost echelon of corporations” (Johnson, 2004: 39), are thought to play the critical roles of monitoring and advising management as well as helping firms to manage resource dependence (Hillman & Dalziel, 2003; Johnson, Daily, & Ellstrand, 1996). It is thus widely believed that a firm’s board can and should influence the firm’s financial performance. Regardless of the differences in their theoretical perspectives, researchers examining the performance effects of corporate boards have predominantly focused on boards’ formal, structural attributes. But decades of research have found no evidence of systematic performance effects of board attributes such as leadership structure and inside/outside director ratio (Dalton, Daily, Ellstrand, & Johnson, 1998; Dalton, Hitt, Certo, & Dalton, 2007; Johnson et al., 1996; Zahra & Pearce, 1989).
1.1.3 Commercial Banks in Kenya
The banking industry in Kenya comprises of the Central Bank of Kenya as a regulatory authority, commercial banks, non-bank financial institutions, Forex bureaus and deposit taking microfinance institutions (Central Bank of Kenya Banking Supervision Report, 2011). At the moment there are 46 financial institutions in the banking industry of which 43 are commercial banks and 1 is a mortgage finance company. Furthermore, there is 1 deposit taking microfinance institution and 130 Forex bureaus (Ibid, 2009).

The commercial banks and mortgage finance companies are licensed and regulated under the Banking Act and Prudential Guidelines. On the other hand, deposit taking microfinance companies are licensed and regulated under the Microfinance Act. Forex bureaus are licensed and regulated under the Central Bank of Kenya Act and Forex Bureau Guidelines.

Out of the 43 institutions, 31 are locally owned and 12 are foreign owned. The locally owned financial institutions comprise 3 banks with significant shareholding by the government and state corporations, 27 commercial banks and 1 mortgage financial institution.

1.2 Problem Statement
Board diversity as a corporate governance concept has recently caught the attention of policy makers, managers, directors, shareholders, and academia (Johansen, 2008). Following this interest, various studies have been undertaken to establish the effect of board diversity on firm performance. These studies however, focus on the developed countries. Few studies have been carried out in the developing countries, Kenya being included. The other thing that is evident from the studies from developed countries is that most of the studies focused on the non-financial sector with very few actually dealing with the financial sector. In some cases, the financial sector firms have been eliminated from the sample of firms under study in major developed economies for instance, Minguez-Vera and Campbell (2008) doing a study in Spain eliminated financial sector firms.
Notwithstanding, the findings from the non-financial sector, studies have been inconclusive which Randoy et al., (2006) argue is a result of country differences, legal and cultural differences, timing differences in firm performance measures. This therefore means that the findings of these non-financial sector studies cannot be generalized to the financial sector and do not adequately inform us of the relationship between board diversity and firm performance in other sectors.

In Kenya, scanty of literature can be found on relationship between board diversity and bank performance with exception of Barako& Brown (2008). Barako&Brown (2008) established that board diversity in Kenya’s banking industry leads to improved corporate social reporting. This study however, focused on the relationship between gender diversity and corporate social reporting in commercial banks.

This study may have been timely to establish what effect board diversity would have on performance with specific focus on the business community. This comes in the backdrop of evidence that gender diversity in boardrooms can add value to the firm by creating better client relationships, risk and audit management (Gulamhussen& Santa, 2010). This research therefore seeks to address all these by looking at board diversity in commercial banks in Kenya and tend to answer questions like whether there is any relationship between board diversity and financial performance of an entity and also whether there are any perceived benefits of board diversity in the business environment.

1.3 Objectives of the Study
The study seeks to establish whether there are positive or negative financial implications or benefits arising from the manner in which the corporate board is structured. The specific objectives of the study are:

1. To determine the impact of board diversity towards the performance of the entity and
2. To establish as to whether there exists a causal relationship between specified board characteristics and the financial performance.
1.4 Value of the study
The study will bear the following benefits starting with the corporate and the researcher in that it will help them to know whether there is an impact either positive or negative on the composition of the board of directors to the firm and if yes know how they are going to benefit from the knowledge and enable the researcher fulfil the academic requirements to attain a degree.

The shareholders will be sensitized on the importance of ensuring that the board selected comprise of all or majority of those fields of profession deemed necessary to maximizing the value and wealth of the firm while the board of directors will be made more effective and efficient in their activities that leads to the achievement of objectives such as to deliver value to customers and returns to the shareholders investment. The board will become more aware of how its activities affect the return to shareholders’ value while academicians will gain in having access to the end results of the study and will be in a position to make recommendations arising from its findings for further research on this or other related areas of study.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

From the finance point of view, the stock market provides the best measure of a firm’s worth. A firm is worth only what the market is willing to pay for it (Irungu, 2007). Some scholars had observed that the relationship between board structure (as opposed to board processes) and company performance has been the most-studied aspect among all board investigations (Pearce and Zahra, 1989; Bhagat and Black, 2002). It is often assumed that a company's financial performance is mainly determined by board diversity. Pfeffer (1983) argued that it is not necessary to understand board processes as directors' performance can be inferred from their demographic characteristics. Other scholars have suggested that future research studies on the actual mechanisms and benefits brought by women on boards of directors and board composition would be fruitful extensions of their work (Hillman and Cannella, 2007; Bathula, 2008). Such an assumption requires data-supported justification. Indeed, the analysis of the board composition is important as quantification of board structure and company performance is much easier than that of incorporating board attributes, processes and firm performance.

Freeman (1984) contends that the network of relationships with many groups can affect decision-making processes. This draws on stakeholder theory whose concern is the nature of the relationships in terms of both processes and outcomes for the firm and its stakeholders. This theory focuses on managerial or strategic decision-making and suggests that the interests of all stakeholders have intrinsic value, and no sets of interests are assumed to dominate others (Abdullah and Valentine, 2009). The principal theoretical perspective for examining board role in corporate governance has been agency theory (Jensen and Meckling, 1976). Stewardship theory relates to the board’s task of providing support and advice to management (Davis, 1991). Resource dependence theorists (Hendry and Kiel, 2004) argue that the board is a co-optative mechanism to extract vital resources to company performance, through its members’ networks with other organizations and by linking the firm to its overall environment (Pfeffer, 1973; Pfeffer and Salancik, 1978; Pearce and Zahra, 1992; Hillman et al., 2000). Corporate governance issues gained a worldwide attention in 2001 with the spectacular collapse of Enron, when the boards of directors of many under-performing firms were reluctantly thrust into the spotlight (Tricker, 2009).
Corporate governance also received close attention after the entry of professional managers who wielded power over investors’ resources (King Commission, 2002). Further, inconsistent accounting practices allowed managers to disclose only minimum financial information to shareholders, boards of directors engaged themselves as vendors to reap unfair profits and manipulated shareholders into approving unworthy investments and compromised auditors at meetings.

Ineffective boards whose incompetence and lack of commitment to values as well as obscurity given to minority shareholders required intervention of governments through corporate governance principles and rules. The composition and demographic characteristics of the board have been examined in numerous studies as the key attributes of the board of directors (Pettigrew, 1990; Westphal, 1999).

Board composition subsumes the individual director’s potential to solve the various tasks (Daily, Johnson and Dalton, 1999) and has generally been analyzed by examining the demographic characteristics of the board (Rindova, 1999). Board size and board composition have long been regarded as important components of the governance process for firms in business as it defines the affiliation of each director as either inside or outside board member (Lawrence and Stapledon, 1999; Boone et al, 2007; Tricker, 2009). They play a significant role in the performance of the firms.

2.2 Theories of Board diversity

The predominant theoretical perspective that has traditionally shaped how we think about the function of the board within corporations draws heavily on an agency theory view of the firm, often supplemented with a complementary resource perspective. In both instances the background assumption is that the primary objective of the board is to maximize shareholder value. Within this predominant perspective, diversity is construed in terms of the extent to which the occupational status of an individual might render them more or less independent; the occupational capital and personal attributes.

Veliyath (1999) pinpoints that the board serves as a bridge between owners and managers; its duty is to protect shareholders’ interests. Specifically speaking, taking responsibility for
managing and supervising, the board should monitor managers’ behaviors for shareholders’ interests, make important decisions, employ management team and superintend firms to obey the law.

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2.2.1 Agency theory

Agency theory has provided the primary theoretical lens for studying the relationship between the composition of the board and the value of the firm (Fama & Jensen 1983). From this perspective, the primary function of the board is seen to be the resolution of conflicts of interest between shareholders and the management of the corporation (Brennan & Solomon 2008). The key focus is on the interests and rights of the shareholders (Brennan & Solomon 2008). According to Zahra and Pearce (1983), (Carter et al 2003; Baysinger & Butler 1985) historically, this has been one of the most common theoretical perspectives used in the analysis of boards of directors. The key assumption of this model is that shareholders interests are best served by an independent board of directors.

The agency problem presents an essential element of the so-called contractual view of the company (Jensen and Meckling 1976, Fama and Jensen 1983a, 1983b). Berle and Means (1932) identify that the joint-stock equity structure has led to a transfer of corporate control from individual to professional managers in the joint-stock firm. When control is distinct from ownership, those in control may deploy assets in ways that benefit themselves rather than the owners. These principle–agent problems are the specific result of this separation of ownership and control. More generally, the essence of the ownership and control agency problem is the separation of management and finance (Shleifer and Vishny 1997). This is because an owner or
manager of an enterprise can raise funds from investors either to put into production or to cash out their holdings in the company. Financiers expect and require the manager’s specialized capital to generate returns on their funds. In contrast, the manager needs financiers’ funds. This is because owners’ funds are either not enough to pursue investment opportunities or are necessary to meet the financial obligations of the company. Thus, the agency problem has placed governance issues at the forefront of financiers’ concerns. They seek corporate governance monitoring mechanisms that can provide assurances that their funds are not expropriated or wasted on wealth reducing projects.

2.2.2 Stakeholder theory

Stakeholder theory offers a means of examining links between performance, board diversity, and representativeness that incorporates the qualitative dimensions of these relationships (Hillman, Keim, and Luce 2001; Rowley 2000). Stakeholder theory is interested in occupational or other characteristics of the constituent groups (e.g., clients, donors) that are represented (Donaldson and Preston 1995; Freeman 1984). A stakeholder perspective on governance is particularly relevant to the context of public–private partnerships and other collaborative service delivery arrangements because it offers a “systems-centered” perspective on how constituent interests are represented (e.g., clients, donors, citizens, public agencies) (Gerde 2000).

Stakeholder theory is conceptually related to resource dependence theories in their joint understanding of the value of strategic leadership, but they differ in suggesting that board members who represent stakeholder groups serve not only the interests of the organization but also the interests of other constituency groups (Hillman, Keim, and Luce 2001). Thus, a stakeholder perspective is useful in studies of collaborative performance, where the responsibilities and benefits of partnership are assumed to be shared. Instrumentally, the research question is whether organizations increase their collaborative performance when they include stakeholders from different sectors of their community in governance or decision making (Donaldson and Preston 1995). As we have noted, the association between leadership representativeness and performance may be indirect, dependent on a supportive organizational culture and the quality of diversity management efforts. In other words, stakeholders can only improve performance when they are empowered to lead.
Although stakeholder theory is used mostly in the corporate sector, Scholl (2001) has found some use for stakeholder theory in the public sector to explain managerial decision making, and he has suggested that stakeholder characteristics can influence policy outcomes and the extent of interorganizational collaboration. Stakeholder representation and responsiveness from a public administrator’s perspective can also be framed as a challenge, such that the increased demands of multiple publics strain organizational capacity and threaten accountability (Bryer 2007). However, Leach, Pelkey, and Sabatier (2002) have found in their examination of the impact of stakeholder composition on watershed management projects that stakeholder groups bring relatively similar mutual goals and make generally favorable contributions.

2.2.3 Resource dependency theory

Resource dependence theory has been the primary foundation for the perspective that larger boards will be associated with higher levels of firm performance (e.g., Alexander, Fennell, & Halpern, 1993; Coodstein, Cautam, &Boeker, 1994; Mintzberg, 1983; Pfeffer, 1972, 1973; Pfeffer&Salancik, 1978; Provan, 1980). In this view, board size may be a measure of an Organization's ability to form environmental links to secure critical resources (Coodstein et al., 1994).

Pfeffer (1973) and Provan (1980), for example, demonstrated that board size was associated with a firm's ability to extract critical resources such as amount of budget, external funding and leverage from an environment. Birnbaum (1984), in a finding also consistent with the tenets of resource dependence, reported that environmental uncertainty (lack of information and volatility) led to increased board size. Booth and Deli (1996), too, noted that the size of a board would reflect the extent of a firm's contracting environments.

Research on board interlocks may also provide a rationale for expecting larger boards to be associated with positive corporate outcomes (e.g., Bazerman&Schoorman, 1983; Burt, 1980). There is some evidence, for example, that board interlocks are associated with effective capital acquisition (e.g., Burt, 1983; Mizruchi& Stearns, 1988; Stearns &Mizruchi, 1993). It may be that larger boards provide more possibilities for such interactions.

The expertise-counsel account of board service suggests that directors may provide CEOs with advice of a quality unobtainable from other corporate staff (e.g., Zahra & Pearce, 1989).
Lorschand Mac- Iver reported that many directors are themselves CEOs: "CEOs have the most relevant experience and expertise to be effective directors. CEOs understand the complex problems of running a major enterprise and, it is argued, provide the best counsel and advice" (1989: 174). This view is consistent with the finding that directors consider "their key normal duty" to be that of advising the CEO of the company on whose board they sit (Lorsch& Mac-Iver, 1989: 64). A larger board with more CEO members, then, may offer an exceptional level of high quality advice and counsel to a CEO.

2.3 Measures of variables

Within this prevailing shareholder value focus, the notion of diversity is discussed in three senses: employee status; occupational attributes and personal attributes.

2.3.1 Employee status

Employee status relates to the board members status as an employee of the firm. One strand of the debate on board composition relates to whether board members should come from inside or outside the organisation. Some authors suggest that none or only very few of the members of the board should be or have been employees of the corporation (Gupta et al 2008; Louden 1982; Stone 1975). These authors place a premium on the independence of the board. Some suggest that insiders can be more effective because of their knowledge of the firm. Others however suggest that insiders are not independent and that their appointment to the board is often used as a way of ensuring the flow of information from the board to others within the organization (Baysinger& Butler 1985). Finally, some suggest that there should be a mix of insiders and outsiders (Fama& Jensen, 1983).

2.3.2 Occupational or professional attributes

Occupational or professional attributes refer to the perceived advantages of having lawyers, financiers and so on, as members of the board. From this perspective, these individuals are seen to represent helpful connections to external institutions like finance houses. These types of directors are seen to serve an instrumental function by linking the organization to other important institutions (Baysinger& Butler 1985; Burt 1980; Pfeffer, 1972, 1976; Thompson 1967). Some of the literature discusses both these concepts in terms of the kinds of capital that individual board
members bring to the organisation. Nicholas van der Walt and Coral Ingley (2003) for example discuss board diversity from a social capital perspective.

2.3.3 Personal attributes
The notion of diversity is also discussed in relation to personal attributes like age, biological gender, ethnicity (Erhardt et al et al 2003; Milliken & Martins, 1996) and even different cognitive styles (Simons &Pelled 1999). Recent developments within corporate governance policy focus on this latter type of diversity in personal attributes.

The majority of the mainstream literature on board diversity is therefore reflective of an entrenched shareholder ideology (Engelen 2002). The board is viewed as a site for the negotiation of just two sets of interests: shareholders and managers. It is assumed that the primary objective of the board is to maximise shareholder value and this orientation is justified in terms of shareholders’ property rights. It is also important to note the extent to which this perspective constructs and sustains notions of difference. Beyond the different interests of shareholders and management, diversity is construed in relatively ideologically benign ways in terms of professional affiliation; independence and individual cognitive styles for example. There is little sense in which difference and diversity might be seen to represent a fundamental challenge to the prevailing corporate imperative to maximise profit.

2.4 Empirical Literature
Despite this pressure on modern corporations, the existing studies on the impact of board diversity on firm performance show mixed results (Rand\oy et al. 2006). The association between board gender diversity and firm performance shows inconclusive evidence in the non-financial sector studies. The effect of board gender diversity on firm performance is believed to arise because of the benefits that accompany board gender diversity. This was explained intuitively by Robinson &Dechant (1997). It is argued that this diversity promotes a better understanding of the marketplace in which a firm operates.

Since the marketplace itself is diverse, gender diversity will make it easy for firms to penetrate these markets. Robinson &Dechant (1997) also noted that diversity in boards increase creativity
and innovation. This view therefore states that the attitudes, beliefs and cognitive functioning of humans are not distributed in a random pattern but appear to be systematically distributed with variables like gender, race and age. It is further noted that diversity especially in terms of gender leads to greater problem solving. This is because many alternatives are carefully evaluated in terms of pros and cons.

Some researchers have actually established that a board that is diverse in terms of gender is likely to have positive impact on its performance. For instance, (Erhardt et al. 2003) established that a company that has got women and minority groups as part of its directors tend to have positive impact on performance. Erhardt, Werbel, & Shrader, (2003), carried their study in the US for a period six years starting from 1993 to 1998. The performance here was measured by return on assets and return on investment. Their study looked at large companies in all the industries in the US. Even though, the findings of this study were positive, it will be hard to attribute the positive results to women directors only as minorities are also included. The minority could even be male directors who come from minority tribes or groups.

Several other researchers have come to the same conclusion that board diversity has positive effect on firm performance. Minguez-Vera & Campbell (2008) for instance, found this to be the case in Spain. Even though firm performance was measured by Tobin’s Q, the results were similar to those of accounting measures like return on assets and return on investment. This study however did not consider all firms in Spain in that financial sector firms were eliminated from the sample. This study also focused on only companies listed on the continuous market of Madrid.

Other authors, in particular those from Australia have established that diversity is positively related to firm value e.g. (Nguyen et al. n.d.); (Bonn 2004). Firm value was measured by Tobin’s Q. These studies involved large firms on the Australian stock exchange for a period of two years from 2000 to 2001. They also applied 2SLS methodology in its analysis of the effect of gender on performance.
In as much as different studies from different countries have established positive impact of board diversity on firm performance, others still established negative impact. This shows how inconclusive the concept of diversity is. For instance, (Bohren & Strom 2007) established negative relationship between board diversity and firm performance for the Norwegian firms. This is in contrast to other studies in the Scandinavian countries which established no relationship at all e.g. (Randoy et al. 2006). Randoy et al. (2006) while undertaking a study in the Nordic countries of Denmark, Norway and Sweden established that diversity in corporate boards do not have any effect on the performance of the firms. They measured performance by the return on assets.

At the same time, a study by (Rose 2007) in Denmark established similar results to those of Randoy et al. (2006) that board diversity has no effect on firm performance. Rose’s study however focused on listed companies and employed Tobin’s Q as its performance measure as opposite to Randoy et al. (2006) who employed returns on assets. This study as well focused on country only. Contrary to the studies of Randoy et al. (2006) and Rose, (2007)(N. Smith et al. 2006) established that board gender diversity has a positive effect on performance of firms in Denmark. Their study focused on the large 2500 Danish firms during the period 1993-2001. However, their study used performance measures such as gross value added to net turnover, profit on ordinary operations to net turnover, ordinary result to net assets and net result after tax to net assets which may be considered weak. One thing that is common among these studies from Scandinavian countries is that they majorly focused on non-financial firms.

In one study carried out in Ghana, Adusei (2010) established that board size has an effect on performance in banks. He alluded to the fact that small boards have positive effect on performance of the firm as measured by return on equity. In yet another study on board size, Staikouras et al. (2007) established among the 58 banks in Europe that large boards hurt the performance of banks. This therefore means that the smaller the board the higher the performance of the bank. In as much as some studies have established that board size has an effect on performance, other studies also such as those of Adams and Mehran (2005); Belkhir (2009), found no effect between board size and firm performance. Specifically, Belkhir (2009)
while carrying a study on 174 US bank and savings institutions did not report any positive relationship between board size and performance as measured by Tobin’s Q.

Looking at board composition, Staikouras et al. (2007) find that board composition does not affect firm performance although its relationship with performance was found to be positive. These findings were similar to those of Adusei (2010) who found no relationship between board composition and bank performance in Ghana although board composition as found to have positive effect on bank efficiency. At the same time, Alonso and Gonzalez (2006) studied 66 banks in OECD countries from 1996 to 2003. They established an inverted U shaped relation between the measures of bank performance (Tobin’s Q, ROA, the annual market return of a bank shareholder) and board size which they posit justifies a large board but imposing an efficient limit on size.

Their findings as well indicate a positive relation between the non-executive directors and performance. Moreover, Busta (2007) sampled 69 listed banks from the EU banking sectors over the period 1996-2005 and 125 banks operating in EU-15 and Switzerland during 2004. The findings for the 69 listed banks indicate that a higher presence of outside directors on boards perform better in terms of the market-to-book value and return on invested capital, in Continental Europe, while negative results were obtained in the case of UK banks.

Busta (2007) finds no evidence of a significant association between board composition and ROA. At the same time, the effect of the board size, although positive, was insignificant in all cases. The results from the 125 banks show that board size has a positive relationship with the market-to-book ratio and return on investment capital and negatively related to return on assets; however it is insignificant in most cases.

Zulkafli and Samad (2007) examined 107 banks in 9 Asian markets in 2004. Their findings suggest no significant relationship between performance measures (e.g. return on assets and Tobin’s Q) and the board size or composition. Lastly, based on a sample of large publicly traded US banks, Pi and Timme (1993) reported that cost efficiency and return on assets are insignificantly related to the percentage of inside (outside) directors.
Carter et al. (2003) explain the relationship between board diversity and firm performance based on the agency theory and they posit that board diversity enhances the board’s ability to monitor top management. In addition to this, they argue that increasing the number of female directors may increase board’s independence since women tend to ask questions that male directors may not ask.

In addition, Smith et al. (2006), posit that board diversity enhances problem solving as a variety of perspectives arise hence more alternatives are evaluated in the process. Furthermore, a more diverse board may also improve a firm’s competitive advantage provided it improves the image of the firm and if this has a positive effect on customers’ behavior and thus on a firm’s performance (Smith et al., 2006).

2.5 Summary of literature review

Board composition subsumes the individual director’s potential to solve the various tasks (Daily, Johnson and Dalton, 1999) and has generally been analyzed by examining the demographic characteristics of the board (Rindova, 1999). Board size and board composition have long been regarded as important components of the governance process for firms in business as it defines the affiliation of each director as either inside or outside board member (Lawrence and Stapledon, 1999; Boone et al, 2007; Tricker, 2009). They play a significant role in the performance of the firms.

Recent corporate reforms encourage women participation in corporate governance practices. The aim is to promote gender diversity in the boards. Firms have been pressured by institutional investors, shareholder activists and interest groups to appoint directors with different ethnic and gender backgrounds as well as bases of expertise and age differences to their boards (Van der Walt et al., 2006). The underlying assumption is that greater diversity should lead to less insular decision-making processes and greater recognition of change (Westphal and Fredrickson, 2001; Bathula, 2008). Bilimoria (1994) argued that women executives bring fresh and well-informed views related to market, environment and ethical issues and have an impact on the decision-
making process of corporations and that boards with more than one female director have a
greater influence over strategic decisions.

Therefore, the diversity in the board of directors, whether viewed from one or a combination of
attributes, can directly or indirectly explain company performance.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter tends to give an overview of the methods of data collection that was used, the methodology in which the data collection procedure followed and at the end tends to give the population that was used in the arriving of the conclusions thereof.

3.2 Research Design

This study was considered causal since it attempted to analyze relationship between board diversity and bank performance. Further to this, the study was explanatory in nature as it established whether the characteristics including profession, experience and exposure caused banks performance to change.

The effect of diversity on bank performance was analyzed over a five-year period from 2007 to 2012. This period was picked so that it would be easier and faster to establish the real effect of diversity on bank performance at least for the boards where there could have occurred these diversity changes or alignment and since a board has a life span of six years, it followed then that the entire board had been constituted or changed.

3.3 Population and Sampling

The target population for this study was all the commercial banks in Kenya. These banks are forty four (44) in number as per the Central Bank of Kenya’s Banking Supervision Report of 2011. All these banks were studied since a conclusive and whole representative analysis was to be arrived at in the end.

3.4 Data Collection and Description

The pertinent data for the study was obtained from secondary sources. Data on financial performance was readily available in secondary sources. These included the Nairobi Securities Exchange (NSE) annual publication, the NSE Handbook (2009) and the firms’ annual reports.
financial data from financial statements of the commercial banks. This was taken because this type of data was easily accessible from the Central Bank of Kenya (CBK) and the Banking Survey Reports of 2010 and 2011.

3.5 Data Analysis & technique

Regression analysis was applied to establish the relationship between the board of directors’ attributes and firm performance. Regression analysis was also used to examine the relationship between variables especially the extent to which a dependent variable was a function of one or several independent variables (Hair et al., 1998; Saunders et al., 2007). Descriptive statistics was used to profile the board of directors of the target firms.

Regression model was used to analyze the quantitative data collected in this study. Regression was used because it was the most common model used by many researchers. Also regression could be used to show the relationship between variables. It does not only show positive, negative or no relationship but also tells the strength of that relationship (Jonson and Kuby, 2007). Specifically, regression was used as it was anticipated that there would be some inter-relationship among some independent variables.

A financial year unit of analysis was used to examine the influence of board attributes on firm performance. With six firm-year records, Ordinary Least Square (OLS) Random-Effects models was applied to test the hypotheses due to the important assumptions of homoscedasticity and no serial correlation in pooled data. An OLS regression was suitable since it corrects for omitted variable bias, and presence of auto-correlation and heteroscedasticity in pooled time series data. This methodology allowed researchers to examine variations among cross-sectional units simultaneously with variations within individual units over time (Bathula, 2008). It assumed that regression parameters did not change over time and did not differ between various cross-sectional units, enhancing the reliability of the coefficient estimates.

An important assumption for choosing random-effect estimation was that the unobserved heterogeneity could not be correlated with the independent variables.

Before performing the regression analyses, the variables were tested for multi-collinearity following the procedure in Hair et al., (1998). The method was appropriate for the study because
it had one independent variable (board diversity attributes) and one dependent variable (financial performance). Other scholars had used similar methods in their studies on corporate governance and performance. Those scholars had developed a system of simultaneous equations where performance measured by Tobin’s Q and is related to corporate governance practices (Bathula, 2008).

According to the methods used and proposed above, this study constructed a regression model for carrying out empirical analysis.

Model: The relation between board diversity and firm performance

\[ \text{Performance}_{it} = a_0 + b_1x_1 + b_2x_2 + b_3x_3 + e_{it} \]

Where

\( \text{Performance}_{it} = \) The return of assets, the return of stocks and Tobin’s Q of firm \( i \) in year \( t \)

\( B_1X_1 = \) The average age of the directors at time \( t \) in company \( i \)

\( B_2X_2 = \) The average period of experience and exposure of directors in the board meetings

\( B_3X_3 = \) The ratio of gender equality between men and women sitting at one time in the board
CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction

Board diversity was looked at in three independent fronts. The aim was to ascertain whether experience diversity, gender diversity and profession diversity causes bank performance to change.

Control variables used in the three separate hypotheses was the board size and the bank size based on the Net Assets of the respective companies. Out of the 44 banks, only data for 33 banks was useful since all research variables were represented.

4.2 Experience Diversity

Experience was evaluated on the Coefficient of Variation of the directors. \( C.V = \frac{\text{S.D} \times 100}{\text{Mean}} \) % was used as the measure of this diversity since the data in this case was continuous. Many research practitioners have used this as formula to calculate diversity on continuous data. (Allison, 1978; Wiersema and Bantel, 1992; Knight et al., 1999).

Linear regression method is used in checking the relationship of variables and testing the hypotheses framed in the study. Linearity of variables and normal distribution of data which are assumed for regression analysis are also checked for the data.

Results

Table 4.1. Test statistic on the Experience Diversity and Return on Assets

ANOVA*

<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>1 Regression</td>
<td>19.290</td>
<td>3</td>
<td>6.430</td>
<td>4.628</td>
<td>.009b</td>
</tr>
<tr>
<td>1 Residual</td>
<td>40.294</td>
<td>29</td>
<td>1.389</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>59.584</td>
<td>32</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
a. Dependent Variable: Return On Assets

b. Predictors: (Constant), Bank of size based on Net Assets, Experience Diversity, Board Size

**Table 1.** represents analysis of variance of Experience Diversity and Return on Assets. The F statistic (4.628) and the sig <0.05 state that there is a slight significant linear relationship.

**Table 4.2 Results on Experience Diversity and Return on Assets**

<table>
<thead>
<tr>
<th>Coefficientsa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
</tr>
<tr>
<td>Experience Diversity</td>
</tr>
<tr>
<td>Board Size</td>
</tr>
<tr>
<td>Bank of size based on Net Assets</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return On Assets

**Table 4.2** represents the coefficient of regression model for Experience Diversity and Return on Assets. The t statistic (0.665) for this regression model is not significant, meaning that Experience Diversity within the commercial banks in Kenya have no net effect on bank performance. Also correlation coefficient equals (0.105), which signifies a weak relationship of
the variables. It can however be seen that despite the insignificant relationship, the relationship is positive. Hypothesis 1 is thus rejected. However, the t statistic on Bank size (3.590) is highly significant, suggesting that the Bank Size has a net effect on bank performance. Board size has no net effect due to the insignificant t statistic (1.458).

4.3 Gender Diversity

The degree of heterogeneity of each variable was calculated using Blau's index (1977) specified as follows:

\[ 1 - \lambda = 1 - \sum_{i=1}^{K} \tilde{p}_i^2 = 1 - \tilde{1}^2D \]

where \( \tilde{p}_i \) is the percentage of individuals in the ith category.

A perfectly homogeneous board would have a diversity index score of 0. A perfectly heterogeneous board would have a diversity index score of 0.5 (assuming infinite categories with equal representation in each category). Gender is a dichotomous variable with 0 for male and 1 for female. In order to calculate diversity on this variable, I used Blau’s index.

Control Variable

In the analysis, a control variable of Board size and Bank size was used. The size of the Board is likely to affect both the demographic heterogeneity and the social network structure of the team. As the size of the board increases, the likelihood of at least one member of the team differing in gender also increases.
Results

Table 4.3 Test statistics on Gender diversity

ANOVA\(^a\)

<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>20.485</td>
<td>3</td>
<td>6.828</td>
<td>5.065</td>
<td>.006(^b)</td>
</tr>
<tr>
<td>Residual</td>
<td>39.099</td>
<td>29</td>
<td>1.348</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>59.584</td>
<td>32</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return On Assets

b. Predictors: (Constant), Bank of size based on Net Assets, Gender Diversity, Board Size

Table 3 represents analysis of variance of Gender Diversity and Return on Assets. The F statistic (5.065) and the sig <0.05 state that there is a slight significant linear relationship.
From table 4 above, the relationship between Gender Diversity and ROA is depicted to be negative with a coefficient of (-0.186). Its t-statistic is (-1.158) whereas the corresponding p-value is (0.256). Gender diversity was found to have no significant value to the bank performance just as was the case with experience diversity. In any case the coefficient for Experience Diversity was higher than that of gender diversity.
4.4 Profession Diversity

Profession diversity was calculated on the basis of the professional qualifications of the board of directors. Adversely stated, there were two options to categorise the directors. This was whether one had a business or finance qualification and the other was a technocrat from a different field all together. In order to calculate diversity on this variable, I used Blau’s index based on the dichotomous nature of the variable.

\[ 1 - \lambda = 1 - \sum_{i=1}^{k} p_i^2 = 1 - 1/D^2 \]

A board of directors full of professionally qualified business graduands would be considered homogeneous have a minimum score of 0 while a completely heterogeneous board of directors will have a maximum score of 0.5.

The control variables used was the board size and bank size.

Results

**Table 4.5. Test statistics on the analysis of profession diversity**

<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>1</td>
<td>Regression</td>
<td>19.124</td>
<td>3</td>
<td>6.375</td>
<td>4.569</td>
</tr>
<tr>
<td>1</td>
<td>Residual</td>
<td>40.460</td>
<td>29</td>
<td>1.395</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Total</td>
<td>59.584</td>
<td>32</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return On Assets

b. Predictors: (Constant), Bank of size based on Net Assets, Profession Diversity, Board Size
Table 4.5. Represents analysis of variance of Profession Diversity and Return on Assets. The F statistic (6.375) and the sig <0.05 state that there is a slight significant linear relationship.

Table 4.6. Results on analysis of variance of Profession Diversity and Return on Assets

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>Sig.</th>
<th>Correlations</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>3.178</td>
<td>.752</td>
<td>4.224</td>
<td>.000</td>
<td></td>
</tr>
<tr>
<td>Profession Diversity</td>
<td>.993</td>
<td>1.752</td>
<td>.105</td>
<td>.567</td>
<td>.575</td>
</tr>
<tr>
<td>Board Size</td>
<td>-.183</td>
<td>.123</td>
<td>-.333</td>
<td>-1.488</td>
<td>.148</td>
</tr>
<tr>
<td>Bank of size based on Net Assets</td>
<td>1.359E-005</td>
<td>.000</td>
<td>.690</td>
<td>3.559</td>
<td>.001</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return On Assets

The coefficient of Profession Diversity (0.105) is found to be insignificant based on its p-value which is (0.575). The other control variables and their respective coefficients and p-values are as shown in the table.

Interestingly though is that profession Diversity has a positive relationship with bank performance. It can be stated that most of the companies tend to have many business technocrats constituting the board of directors. It is of interest to see the engagement of more professionals from outside assimilated to the board as it is suggested that it may have a significant effect on performance.
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This study’s main focus was to examine the relationships between board of directors’ diversity and corporate performance. Findings show that statistically significant negative relationship exists between: ROA and women on the board and experience and exposure of the board members while same findings show that statistically significant positive relationship exists between: ROA and educational qualifications and board member professional specialization.

5.2 Summary

One of the main findings of this study is that board gender and experience as elements of board diversity has no significant effect on the performance of banks whereas it has clearly proved to be that professional attributes or profession has a relationship with the same banks performance. This is shown by a statistically insignificant relationship between board gender diversity and bank performance. These findings suggest that diversity could be an important corporate governance concept in other business facets as opposed to boardrooms. Whatever measure that could be taken to improve gender or experience attributes of the board diversity may not be seen negatively by the business community since it does not have any effect on the bottom-line of banks. This is consistent with Campbell and Minguez-Vera (2008) who suggested in Spain that the market does not punish firms that have included female directors on the boards since board gender diversity was found to have no effect on performance.

5.3 Conclusions

These findings could be like this may be because majority of the boards are male dominated and the few women that are on the board may not be having any influence on the strategies of the bank. It would be interesting to see what would happen if the numbers female directors were to increase dramatically.

Majority of the banks had no female director on their boards. And for those who had female directors on their boards the number was so small. Majority of those banks had only one female director which could point to tokenism as explained by Kanter (1977). Tokenism is whereby percentages of representation in the community fall below 15%, those who are different are seen
as representing their category rather than being seen as individual, because they are so unusual (Singh and Vinnicombe, 2004). Tokens are always accommodated by having public face at work while keeping private face hidden. Since women on the board are minority it points then that women are tokens in the banking industry giving a hand to the tokenism theory.

Another possible interpretation of this phenomenon could be that there may be glass ceiling in majority of the banks in Kenya. Since board members are the most senior people in organization as some of them rise above the ranks and become board members. If this is the case, then many female employees face glass ceiling (i.e. promotion to a certain level but not beyond) in those organizations (Williams 1992).

Few women on the board may have come about also because may be women in general do not have the necessary training and experience to work in the financial sector. Although, in one study in the UK, it was established that number of female directors on the boards of finance and utilities and transport industry was higher as compared to other industries (Grosvold et al. 2007). The findings on the number of female directors on the Kenyan boards could also point to the fact that there is a glass ceiling on women in many organizations.

5.4 Limitations

Notwithstanding of the above findings, the study has some limitations. No research can be comprehensive and this research addresses only some elements of corporate governance and is restricted to commercial banks in Kenya. Some of the limitations of this study are presented here. First, the main limitation of the study is that the data was collected through publicly available data sources such as annual reports mainly from the central bank of Kenya. If there were any problems relating to data disclosures or professional accounting practices, then that would limit the validity of the findings. Second, the entire population comprised of only 44 firms, which is relatively small. Due to data problems, the final set comprised of 198 firm-year observations for 33 firms. Nonetheless, the size of the sample was limited by the mergers and acquisitions lately done, collapse of banks between the year of study among other reason.
5.5 Suggestions for Further Research

The external validity of the current study may be in question, since the data belongs to only Kenyan firms which are few compared to those operating or doing the same business across the world. Future research should address the limitations of this study. Several extensions to this study are possible. First, the study focused only on certain set of board attributes for their impact on firm performance. The starting point is to consider directors’ functional area knowledge. Finally, the study has examined the impact of board variables on firm performance, as measured by return on assets, return on equity and net assets. It may be useful to re-examine this further using other market based performance variables such as Tobin’s $Q$ and compare the relationship (Bathula, 2008). This may be particularly useful in a fluctuating market and how firms change the board characteristics in response to change in firm performance.
References


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King Committee and Commission on Corporate Governance (2002). King 2 Report on Corporate


Journal, 36: 603-618.


APPENDIX I: COMMERCIAL BANKS IN KENYA

The following are the commercial banks which have been operating in Kenya lately. Most of them have their head offices in Nairobi.

**Foreign Banks**

1) Bank of Africa, Nairobi
2) Bank of India, Nairobi
3) Citi bank, Nairobi
4) Habib Bank, Nairobi
5) Habib Bank A.G Zurich, Nairobi

**Foreign Owned but Locally Incorporated Banks**

1) Barclays Bank of Kenya, Nairobi
2) Stanbic Bank, Nairobi
3) Standard Chartered Bank, Nairobi
4) Diamond Trust Bank, Nairobi
5) Bank of Baroda, Nairobi

**Banks with Government Participation**

1. Stanbic Bank, Nairobi
2. Development Bank, Nairobi
3. Consolidated Bank Of Kenya Ltd
4. Industrial Development Bank, Nairobi
5. Kenya Commercial Bank, Nairobi
Banks Locally Owned

1) African Banking Corporation, Nairobi
2) African Development Bank, Nairobi
3) Akiba Bank, Nairobi
4) Bankers Trust, Nairobi
5) Biashara Bank of Kenya, Nairobi
6) Victoria Commercial Bank, Nairobi
7) CFC Bank, Nairobi
8) Transnational Bank Ltd
9) Credit Bank Ltd
10) Guardian bank Ltd
11) Investment &Mortgages Bank Ltd
12) Middle East Bank (K) Ltd
13) Akiba Bank Ltd
14) Fina Bank Ltd
15) Imperial Commercial Bank
16) Victoria Commercial Bank
17) Prime Bank Ltd
18) Equatorial Commercial Bank
19) Giro Commercial Bank
20) Biashara Bank Ltd
21) Africa Banking Corporation Ltd
22) Chase Bank Ltd
23) City Finance Bank, Nairobi
24) Commercial Bank of Africa, Nairobi
26) Cooperative Bank of Kenya, Nairobi
27) East African Development Bank, Nairobi
28) Equity bank