THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND RISK MANAGEMENT PRACTICES AMONG COMMERCIAL BANKS IN KENYA

BY

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A MANAGEMENT RESEARCH PROJECT PROPOSAL SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

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DECLARATION

This management research project is my original work and has not been presented for examination in any other university.

Signed. ................................................................. Date. 18.11.2019.

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D61/70273/2009

This management research project has been submitted for examination with my approval as university supervisor.

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DEDICATION

To my family, you made me who I am today
Increased concerns regarding corporate accountability in various developed nations have been associated with the need for appropriate risk management and internal control systems. Uncertainty regarding the association between the focus of voluntary corporate governance guidelines and risk management and internal control activities in practice has created a research gap in this area. The objective of this study was to establish the relationship between corporate governance and risk management practices of commercial banks in Kenya.

The present study used a cross-sectional survey design. The population of this study was all the 44 commercial banks which had been operating in Kenya for at least five years. Data was obtained from primary and secondary sources. Data on risk management was collected through a questionnaire designed for the risk managers in each of the banks. Corporate governance data was collected from the annual statements. The data sought was on board dimensions such as size (BOARD_SIZE), CEO duality (CEO_DUAL) and diversity (BOAD_DIV). Data was analysed using regression analysis.

The study found that the level of corporate governance was moderate as shown by the mean score of 3.048. The study found that the most managed risk in the banking sector was foreign currency risk (4.22). This is followed by interest rate risk (4.11) and equity price risk (3.44). The least managed risk was commodity price risk (1.78). The study also noted a high significant positive correlation between risk management and corporate governance (R = 0.754, p<0.05). The study also concludes that there is a significant influence of corporate governance on risk management practices of commercial banks in Kenya. The study recommends need for banks to entrench more measures to manage
risks. The study also recommends that the banks should also work on enhancing their corporate governance in terms of board characteristics.
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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The current global financial crisis has seen the collapse of numerous businesses internationally, demonstrating that no industry or jurisdiction is immune to inadequate or inappropriate risk management. All businesses need to have the capacity to develop policy with a full appreciation of risk and the development of a suitable set of operating procedures in order to respond to changing circumstances in a timely manner. In the light of the current global financial crisis, the present paper seeks to discuss the need for appropriate risk management, planning, and control and the need for companies to reassess their governance structure to ensure adequate risk management.

1.1.1 Concept of Corporate Governance

Corporate governance is a very general phrase, denoting, as the Cadbury Report (1992), states, “the system by which companies are directed and controlled.” It is concerned with structures and the allocation of responsibilities within companies. More specifically, discussions on corporate governance have concentrated on the relations between the directors and managers of the corporation and other parties. The parties concerned have varied. Dimsdale and Prevezer (1994) observe that corporate governance is concerned with the way in which corporations are governed and in particular in the United Kingdom the relationship between the management of a company and its shareholders. This focus in corporate governance has continued to underlie the provisions of subsequent corporate governance reports in the UK, including Greenbury Report (1995), Hampel Report (1998), Turnbull Report (1999), Higgs (2003), and Smith Report (2003).
As financial institutions usually act partly in the capacity of fund managers, it should not be assumed that agency relationships within the industry will be primarily defined in terms of shareholdings. In fact, a number of financial institutions have no shareholders and fall within other categories of organization in which Jensen and Meckling (1976) warned that agency problems would arise. However, even for companies in this field, there are usually numerous agency relationships with providers of funds which arise from the company's activities as a fund manager and which are encompassed by the OECD's principles but tend to be neglected by the Cadbury report and its successors.

1.1.2 Concept of Risk Management

Business risks are defined by the Institute of Internal Auditors Research Foundation (IIARF) as "threats to achieving the entity's objectives" (IIARF, 2003). They are uncertainties about events and/or their outcomes that could have a material effect on the goals of the organisation (Selim and McNamee, 1999). The management of risks is an integral part of good business practice. It has been carried out on an ongoing and informal basis by many organisations. Traditionally, risk management has developed as a professional and technical discipline in a number of key areas, namely finance, health and safety, clinical and environmental areas.

Organisations are increasingly facing a variety of risks including financial, operational, reputation, regulatory and information risk (Burlando, 1990; KPMG, 2001). Information about an organisation's risk is not only important to management and shareholders, but also to suppliers, creditors, employees and other stakeholders. The information is useful to management and shareholders as it indicates the stability of the organisation's processes and expected results. Further, such information is also useful for creditors for
assessing a company's ability to settle its financial liabilities, for suppliers in relation to their decisions about future credit terms, and for employees assessing their future prospects in the organisation (Korosec and Horvat, 2005). Therefore, proper risk management support structures are likely to help in managing business risks more effectively and in disclosing the risk management outcomes to the organisation's stakeholders.

1.1.3 Corporate Governance and Risk Management

Corporate collapses such as Enron and high profile legal actions in the US and elsewhere in the late 1990s and early 2000s highlighted the need to make management and directors of public companies more accountable and have led governments to actively promote higher standards of corporate governance. In the United States, the Sarbanes-Oxley Act of 2002 addressed corporate responsibility and the ethics of senior financial officers (Commission for European Communities, 2005). In the aftermath of the recent corporate collapses, numerous governance initiatives have been proposed for improving corporate governance with significant emphasis placed on the role of risk management. An effective risk management system is seen to help the organisation achieve its business objectives, enhance its financial reporting as well as safeguard its reputation.

Organisations however tend to differ in their approaches, the structures and processes adopted towards managing risks. While traditionally significant attention has fallen on the audit committee for achieving proper risk management (Korosec and Horvat, 2005), in more recent times there has been significant growth in risk management committees (RMCs) which are specialised risk-focused board committees. A RMC is defined as a sub-committee of the board of directors that provides enterprise risk management
education at board level, establishes buy-in at board level for risk appetite and risk strategy, develops “ownership” of risk management oversight by the board, and reviews risk reports of the enterprise (KPMG, 2001). Such a committee is potentially a critical resource for boards in meeting their risk management responsibilities.

1.1.4 Commercial Banks in Kenya

Commercial banks are licensed and regulated under the Banking Act, Cap 488 and Prudential Regulations issued there-under. There are currently 44 commercial banks in Kenya. Out of the 45 institutions, 32 are locally owned and 12 are foreign owned. The locally owned financial institutions comprise 3 banks with significant government shareholding and 28 privately owned commercial. The foreign owned financial institutions comprised 8 locally incorporated foreign banks and 4 branches of foreign incorporated banks. Of the 42 private Banking institutions in the sector, 71% are locally owned and the remaining 29% are foreign owned (CBK, 2009).

The Commercial Banks have been selected for the study because of the recent emphasis on Risk Management in Kenyan Banking driven by the Central Bank viz. the Central Bank of Kenya guidelines as well as banks’ own recent initiatives towards risk management. A process of financial liberalization was initiated in the 90s to make the banking system profitable, efficient, and resilient. The liberalization measures consisted of deregulation of entry, interest rates, and branch licensing, as well as encouragement to state owned banks to get listed on stock exchanges. With the liberalization came risks that banks needed to manage. It is therefore a suitable time to perform an analysis of risk management strategies in Commercial Banks in Kenya. The Basel-II norms, which
include a move towards better risk management practices, also necessitate such a study (CBK, 2009).

1.2 Statement of the Problem

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for appropriate risk management and internal control systems. This has been reflected through recent voluntary corporate governance guidelines. The subjectivity of this area has given rise to different levels of emphasis on risk management and internal control and is, correspondingly, reflected in the governance guidelines of various countries. While these voluntary guidelines that have originated in each country may provide different levels of focus on these two areas, it is uncertain as to what extent these different levels of focus exert an influence, either direct or indirect, on an organisation's risk management and internal control practices. An increasing amount of empirical evidence shows that good corporate governance contributes to competitiveness, facilitates corporate access to capital markets, and thus helps develop financial markets and spur economic growth (Evans and Carson, 2005).

Uncertainty regarding the association between the focus of voluntary corporate governance guidelines and risk management and internal control activities in practice has created a research gap in this area. Beekes and Brown (2006) refer to company responses to such voluntary guidelines as a rich area for research. A literature search in Kenya for studies on relationship between corporate governance and risk management in companies yielded no fruit as most of the studies on corporate governance have focused on its relationship with firm performance. For instance, further, studies on risk management practices in Kenya have also not focused on its relationship with corporate governance. 
mechanisms. For instance, Kioko (2008) did a study on risk management techniques of unsecured loans of commercial banks in Kenya. Kipchirchir (2008) did a study on foreign exchange risk management practices in the motor vehicle industry in Kenya. Ngare (2008) focused on credit risk management practices of commercial banks in Kenya; Njiru (2008) did a study on credit risk management by coffee cooperatives in Embu while Weru (2008) assessed information risk management practices. All these studies did not investigate the link between corporate governance and risk management. There is therefore a gap in literature that the present study sought to bridge.

1.3 Objective of the Study

The objective of this study was to establish the relationship between corporate governance and risk management practices of commercial banks in Kenya.

1.4 Importance of the Study

This study may be important to various groups of people. The commercial banks in Kenya will gain immensely from the results of this study as it will show what relationship exists between corporate governance and risk management practices. This will help the managers in enhancing their corporate governance mechanisms.

The policy makers can obtain knowledge of the financial sector dynamics as regards risk management practices as well as corporate governance in Kenya. They can therefore obtain guidance from this study in designing appropriate policies that may regulate the sector.
The study can provide information to potential and current scholars on risk management and corporate governance among commercial banks in Kenya. This can expand their knowledge on corporate governance mechanisms in financial institutions and also identify areas of further study.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

This chapter presents the literature review. First, a theoretical review is presented based on the institutional theoretical arguments. This is followed by a discussion on risk management, the techniques of risk management, risk analysis and evaluation, and the relationship between corporative governance and risk management. A summary of the chapter is then provided.

2.2 Theories of Corporate Governance

Theories related to corporate governance are discussed in this section. These theories are institutional theories, agency theory, stewardship theory, and stakeholder theory.

2.2.1 Institutional Theories

One of these institutional theoretical arguments is that organisations tend to focus on the pressures and constraints of their environment (Oliver, 1991). This is supported by assertions that organisational choice is limited by a variety of external pressures (Meyer et al., 1983), environments are collective and interconnected (DiMaggio and Powell, 1983; Powell, 1988), and organisations must be responsive to external demands and expectations, in order to survive (Meyer and Rowan, 1977). Institutional theorists (DiMaggio and Powell, 1983; Meyer and Rowan, 1977; Zucker, 1987) have suggested further that institutional constituents that exert pressures and expectations include not only formal corporate governance guidelines, but also public opinion regarding good corporate governance (Scott, 1987).
Another argument is that institutional theorists have emphasized the survival value of conformity with the institutional environment, and the advisability of adhering to external rules and norms (DiMaggio and Powell, 1983). Zucker (1987) argues that organisations are predicted to conform to institutionalized beliefs or practices when the “social fact” quality of these beliefs or practices renders them the only conceivable “obvious” or “natural” way by which to conduct an organizational activity. Therefore, in the context of this study, this institutional theoretical argument illustrates that when corporate governance guidelines obtain the status of a social fact, organisations may engage in complying with such guidelines as they are seen as obvious or proper, as opposed to being calculative and self-interested (Oliver, 1991). This institutional theoretical assertion is used to argue that compliance by commercial banks with corporate governance guidelines may not be linked only to positive organisational outcomes (e.g. higher perceived reliability of financial reporting), but also because it would be unthinkable to do otherwise. In other words, applying corporate governance guidelines may be driven not only by processes of interest mobilisation, as explained by DiMaggio (1988), but also by preconscious acceptance of these institutionalised guidelines.

Another aspect of institutional theory is that an organization’s survival requires it to conform to social norms of acceptable behaviour (Covaleski and Dirsmith, 1988). DiMaggio (1988), DiMaggio and Powell (1983), Meyer and Rowan (1977) and Zucker (1988) suggest that the self-serving advantages of compliance with institutional norms and requirements are revealed in the variety of rewards to which organisational conformity has been related in the institutional literature. Increased prestige, stability, legitimacy, social support, internal and external commitment, access to resources, attraction of personnel, fit into administrative categories, acceptance within professions
and invulnerability to questioning are examples of institutional conformity. The above-noted theoretical institutional assertion is used to argue that commercial banks in Kenya, whether listed or not, comply with corporate governance guidelines so as to conform to social norms of acceptable corporate behaviour. Thus, the specific content of these guidelines, relative to risk management and internal control, exerts an important influence on their risk management and internal control practices. In view of the above-noted institutional theoretical arguments the underlying theory assumes that commercial banks adhere to corporate governance guidelines, even though the guidelines are neither mandatory nor limited to a “comply or explain” principle.

2.2.2 Agency Theory

Agency theory having its roots in economic theory was exposited by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as “the relationship between the principals, such as shareholders and agents such as the company executives and managers”. In this theory, shareholders who are the owners or principals of the company, hires the gents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder’s agents (Clarke, 2004).

The agency theory shareholders expect the agents to act and make decisions in the principal’s interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976).
Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, et al., (1997).

In agency theory, the agent may be succumbed to self-interest, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control (Bhimani, 2008). Holmstrom and Milgrom (1994) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, but it does not eradicate or even minimize corporate misconduct. The positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholders value. Hence, a more individualistic view is applied in this theory (Clarke, 2004). Indeed, agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can be applied to align the goals of the management with that of the owners. Due to the fact that in a family firm, the management comprises of family members, hence the agency cost would be minimal as any firm's performance does not really affect the firm performance (Eisenhardt, 1989).

The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976). This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.
2.2.3 Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Davis, et al., (1997) as “a steward protects and maximises shareholders wealth through firm performance, because by so doing, the steward’s utility functions are maximised”. In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson and Davis, 1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Agyris (1973) argues agency theory looks at an employee or people as an economic being, which suppresses an individual’s own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust (Donaldson and Davis, 1991). It stresses on the position of employees or executives to act more autonomously so that the shareholders’ returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviours (Davis, et al., 1997).

On the other end, Daily et al. (2003) argued that in order to protect their reputations as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders’ profits. In this sense, it is believed that the firm’s performance can directly impact perceptions of their individual performance. Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization,
whilst, Shleifer and Vishny (1997) insists that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance. Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work at them diligently.

Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. It was evident that there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than separated (Donaldson and Davis, 1991).

2.2.4 Stakeholder Theory

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al, (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science.

Stakeholder theory can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. This group of network is
important other than owner-manager-employee relationship as in agency theory (Freeman, 1999). On the other end, Sundaram and Inkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management's attention. Whilst, Donaldson and Preston (1995) claimed that all groups participate in a business to obtain benefits. Nevertheless, Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders.

Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson and Preston (1995) argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests are assumed to dominate the others.

2.3 Concept of Corporate Governance

From a generic perspective, banks are viewed as any firm with a broad range of stakeholders. In the case of banks, the group of claimants includes shareholders, who contribute to the formation of capital, as well as other categories that have a direct interest, such as: creditors, employees, general public, governments and regulators. Referring to corporate governance models and viewing a comparison between the Anglo-American and the Franco-German models, Macey and O'Hara (2003) note the strange fact that paradigms of corporate governance differ on the basis of national boundaries rather than on the basis of the indigenous characteristics of the firms being governed. The Anglo-American corporate governance approach focuses on the interests of maximizing
shareholder value, while the Franco-German model considers the interests of all stakeholders. In the case of banks, the two authors find a hybrid approach, in which most firms are governed according to the US model, while banks are governed according to the Franco-German paradigm. The governance of banks is targeted at the interest of its shareholders, employees, creditors, local communities, customers and regulators.

There is a significant public dimension to the banking firm. In the banking context, depositors' savings and government interests are at stake (Macey and O'Hara, 2003). When the social costs of an outcome exceed the private costs of an outcome, there is a negative externality effect. In this case, the failure of a bank can influence the functioning of the entire banking system. The positive externality effect is also acknowledged: good individual performance improves the health of the banking system, which benefits all stakeholder groups. In this context, the corporate governance model argues that shareholders are not the exclusive beneficiaries of fiduciary duties. Non-shareholder constituencies claim fiduciary duties from management, in certain circumstances requesting higher protection than the duty performed in relation to shareholders. The special nature of banking requires that management duties are more extensive than those of other directors. Managers function in the light of two distinct sets of interests: one is the private interest internal to the firm and the other is the public interest external to the firm. From the banks' governance perspective, the agent seeks that behavior beneficial to the firm's interest does not compromise the public interest (Ciancanelli and Gonzales, 2000).

Corporate governance includes all types of firms and its definitions could extend to cover all of the economic and non-economic activities. Literatures in corporate governance
provide some form of meaning on governance, but fall short in its precise meaning of governance. Such ambiguity emerges in words like control, regulate, manage, govern and governance. Owing to such ambiguity, there are many interpretations. It may be important to consider the influences a firm has or affected by in order to grasp a better understanding of governance. Owing to vast influential factors, proposed models of corporate governance can be flawed as each social scientist is forming their own scope and concerns.

2.4 Risk Management Practices

The banking industry has shifted its attention towards the risk management of operational risk because the latter can have a devastating impact on operations of banks. There is a compelling background for the banking industry’s shift in this way. In managing operational risks, risk managers usually have a large set of methods available out of which an optimal combination should be selected with the aim of maximising business value. Risk prevention and reduction seem to be the most appropriate management devise for operational risk (Korosec and Horvat, 2005).

In their attempt to manage risks, most organisations differentiate between three main types which include risks which must be managed –which are risks where regulatory bodies and/or government demand this of the organisation in a particular field; risks of internal and external fraud and theft inherent in any organisation; and risks which are neither covered by the dictates of compliance with a management method prescribed by an external body nor defined by a clear reason for the organisation to try and manage (Williams et al., 2006).
These third type of risks are optional risks where the organisation can choose whether to manage or not, and to change degree. It is these kinds of risks that the risk management models target (Williams et al., 2006). In order to manage these optional risks, the models suggest that three steps are necessary. These are risk recognition, risk prioritization, and risk management. Risk recognition is the phase of understanding what is at risk and what events could potentially cause harm or benefit.

According to the Committee of Sponsoring Organizations of the Treadway Commission, COSO (2004), enterprise risk management consists of eight interrelated components. These are derived from the way management runs an enterprise and are integrated with the management process. These components are: internal environment, objective setting, event identification, risk assessment, risk response, control activities, information and communication, and monitoring.

The internal environment encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity’s people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate (Nocco and Stulz, 2006). Objectives must exist before management can identify potential events affecting their achievement. Enterprise risk management ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity’s mission and are consistent with its risk appetite (COSO, 2004). Internal and external events affecting achievement of an entity’s objectives must be identified, distinguishing between risks and opportunities. Opportunities are channelled back to management’s strategy or objective-setting processes (Saunders and Cornett, 2006). Risks are analyzed, considering likelihood and
impact, as a basis for determining how they should be managed. Risks are assessed on an inherent and a residual basis.

The management selects risk responses – avoiding, accepting, reducing, or sharing risk – developing a set of actions to align risks with the entity’s risk tolerances and risk appetite (COSO, 2004). Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out. Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity. The entirety of enterprise risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations or both (Beasley, Clune and Dana, 2005).

There have been a large number of studies published about risk management in general. However, the number of the empirical studies on risk management practices in financial institutions was found to be relatively small. Linbo Fan (2004) examined efficiency versus risk in large domestic USA banks and found that profit efficiency is sensitive to credit risk and insolvency risk but not to liquidity risk or to the mix of loan products. Hahm (2004) conducted an empirical study on interest rate and exchange rate exposures of banking institutions in pre-crisis Korea. Results indicated that Korean commercial banks and merchant banking corporations had been significantly exposed to both interest rate and exchange rate risks, and that the subsequent profitability of commercial banks was significantly associated with the degree of pre-crisis exposure. The results also indicated that the Korean case highlights the importance of upgrading financial supervision and risk management practices as a precondition for successful financial liberalization.
Niinimaki (2004) observed that the magnitude of risk taking depends on the structure and side of the market in which competition takes place. The author also concluded that if the bank is a monopoly or banks are competing only in the loan market, deposit insurance has no effect on risk taking. Banks in this situation tend to take risks, although extreme risk taking is avoided. In contrast, introducing deposit insurance increases risk taking if banks are competing for deposits. In this case, deposit rates become excessively high, thereby forcing banks to take extreme risks.

Wetmore (2004) examined the relationship between liquidity risk and loans-to-core deposits ratio of large commercial bank holding companies. The author concluded that the average loan-to-core deposit ratio had increased over the period studied, which reflects a change in the asset/liability management practices of banks. The author also concluded that there is a positive relationship occurring between market risk and the change in loan-to-core deposits ratio after 1994, with a negative relationship occurring before 1994.

Wang and Sheng-Yung (2004) studied foreign exchange risk, world diversification and Taiwanese American depository receipts (ADRs). In this study they tried to answer the following question: Should USA investors purchase American depository receipts issued by Taiwanese multinationals? Empirical results indicated that foreign exchange risk is priced in Taiwanese ADRs. Moreover, Taiwanese ADRs were shown to help USA investors diversify their portfolios globally. These findings suggest that Taiwanese ADRs are valid investment tools for USA investors who seek international diversifications.
Khambata and Bagdi (2003) examined off-balance-sheet (OBS) credit risk across the top 20 Japanese banks. The main results of this study indicated that financial derivatives are heavily used by the top four banks and that loan commitments are the largest source of credit risk among traditional OBS instruments. The results also indicated that there is a wide difference across the banks in the use of derivative leverage. As compared to USA and European banks, Japanese banks use fewer OBS instruments as a percentage of their assets. This implies that Japanese banks are more conservative and risk-averse in general than their USA or European counterparts, especially given the bad financial condition of Japanese banks.

Salas and Saurina (2002) examined credit risk in Spanish commercial and savings banks; they used panel data to compare the determinants of problem loans of Spanish commercial and savings banks in the period 1985-1997, taking into account both macroeconomic and individual bank-level variables. The GDP growth rate, firms, family indebtedness, rapid past credit or branch expansion, inefficiency, portfolio composition, size, net interest margin, capital ratio and market power are variables that explain credit risk. Their findings raise important bank supervisory policy issues: the use of bank-level variables as early warning indicators, the advantages of mergers of banks from different regions, and the role of banking competition and ownership in determining credit risk.

A study by Medanoglu (2005) investigated the concept of risk and its underlying dimensions that influence the restaurant industry's cash flows and stock returns. This study proposed a contemporary framework that enables restaurant industry executives to develop a better understanding of the risk factors (macroeconomic and industry) that influence their firms' cash flows and stock returns. The primary unit of analysis was at
industry (portfolio) level. In addition, as a second step, three restaurant firms were selected to demonstrate the practical application of the model. Exploratory factor analysis indicated that the restaurant industry risk is represented by three dimensions: "Output," "PPI Meats," and "IP Restaurants." The macroeconomic risk construct was represented by the five variables of Arbitrage Pricing Theory. Time series-analysis regression of the portfolio of 75 restaurant firms, for the 1993-2004 period, revealed that macroeconomic variables explained a significant portion of restaurant stock returns. On the other hand, both macroeconomic and industry models explained a significant level of variation in operating cash flows. The addition of September 11 "dummy" variable improved the explained variation in stock returns for both equations (macroeconomic and industry). At a firm level, the industry model accounted for a significant variation in internal value drivers (operating cash flows, food cost, and labor cost) for all three restaurant companies. The industry risk model survived after controlling for the effect of macroeconomic variables on operating cash flows. The results indicate that the industry model provides a parsimonious solution in estimating variation in operating cash flows by capturing macroeconomic effects.

Al-Tamimi (2002) investigated the degree to which the UAE commercial banks use risks management techniques in dealing with different types of risk. The study found that the UAE commercial banks were mainly facing credit risk. The study also found that inspection by branch managers and financial statement analysis were the main methods used in risk identification. The main techniques used in risk management according to this study were establishing standards, credit score, credit worthiness analysis, risk rating and collateral; the study also highlighted the willingness of the UAE commercial banks to
use the most sophisticated risk management techniques, and recommended the adoption of a conservative credit policy.

Oldfield and Santomero (1997) investigated risk management in financial institutions. In this study, they suggested four steps for active risk management techniques; the establishment of standards and reports; the imposition of position limits and rules (i.e. contemporary exposures, credit limits and position concentration); the creation of self investment guidelines and strategies; and the alignment of incentive contracts and compensation (performance-based compensation contracts).

A study by Sensarma and Jayadev (2009) attempted to summarize the information contained in bank financial statements on the risk management capabilities of banks and then ascertain the sensitivity of bank stocks to risk management. The theoretical framework was derived from a bank’s accounting identities. The study interpreted the selected accounting ratios as risk management variables and attempted to gauge the overall risk management capability of banks by summarizing these accounting ratios as scores through the application of multivariate statistical techniques. The study further analyzed the impact of these risk management scores on stock returns through regression analysis. The results, based on data for Indian banks, revealed that banks’ risk management capabilities had been improving over time except for in the last two years. Returns on the banks’ stocks appeared to be sensitive to risk management capability of banks. These results suggest that banks that want to enhance shareholder wealth have to focus on successfully managing various underlying risks. The findings have implications for investors who may benefit by going long on shares of banks that are better risk
managers. The findings are also useful for the regulators in developing quantitative indicators of soundness of the banking system (Sensarma and Jayadev, 2009).

Al-Tamini and Al-Mazrooei (2007) sought to examine the degree to which the UAE banks use risk management practices and techniques in dealing with different types of risk. The secondary objective was to compare risk management practices between the two sets of banks. The authors developed a modified questionnaire, divided into two parts. The first part covered six aspects: understanding risk and risk management; risk identification; risk assessment and analysis; risk monitoring; risk management practices; and credit risk analysis. This part included 43 closed-ended questions based on an interval scale. The second part consisted of two closed-ended questions based on an ordinal scale dealing with two topics: methods of risk identification, and risks facing the sample banks. The study found that the three most important types of risk facing the UAE commercial banks were foreign exchange risk, followed by credit risk, then operating risk. It was also found that the UAE banks were somewhat efficient in managing risk, and risk identification and risk assessment and analysis were the most influencing variables in risk management practices. Finally, the results indicated that there was a significant difference between the UAE national and foreign banks in the practice of risk assessment and analysis, and in risk monitoring and controlling.

Kioko (2008) did a study on the credit risk management techniques of unsecured loans of Commercial Banks in Kenya. The study revealed that the Banks used a combination of credit management methods for unsecured loans. Further, Kipchichir (2008) did a study on foreign exchange risk management practices. The study was a survey of the motor
vehicle industry in Kenya. The results revealed that the most commonly used foreign exchange risk management method was hedging.

In another study by Ngare (2008), credit risk management practices by commercial banks were sought. This was a survey of commercial banks in Kenya. The results revealed a combination of credit risk management methods used by commercial banks in Kenya. Njiru (2003) did a study on credit risk management by coffee cooperatives in Embu District. The study was a survey of coffee cooperatives in the area. The study revealed that the methods were similar to the ones commonly espoused in finance textbooks. Simiyu (2008) on the other hand sought to establish the credit risk management techniques in microfinance institutions in Kenya. The study design was survey of microfinance institutions in Nairobi. The study revealed that the methods did not differ from those of commercial banks. Lastly, Weru (2008) did an assessment of information systems risk management practices. This was a case study. The study revealed that the organization used various information system risk management strategies as recommended by Committee of Sponsoring Organizations of the Treadway Commission, COSO (COSO) framework.

Nocco and Stulz (2006) argued that a carefully designed risk management program - one in which all material corporate risks are viewed and managed within a single framework - can be a source of long-run competitive advantage and value through its effects at both a "macro" or company-wide level and a "micro" or business-unit level. They argued that at the macro level, risk management enables senior management to identify, measure, and limit to acceptable levels the net exposures faced by the firm. By managing such exposures mainly with the idea of cushioning downside outcomes and protecting the
2.5 Empirical Review

A study by Subramaniam, McManus and Zhang (2009) sought to examine how a risk management committee (RMC) as a newly evolving sub-committee of the board of directors, functions as a key governance support mechanism in the oversight an organisation's risk management strategies, policies and processes. Using an agency theory perspective, this study investigated the association between board factors such as proportion of non-executive directors, Chief Executive Officer duality, and board size; as well as, other firm-related factors (e.g. auditor type, industry, leverage, and complexity), and the existence of a risk management committee, and the type of risk management committee (namely, a separate risk management committee versus one that is combined with the audit committee). Data was collected from the annual reports of the top 300 Australian Stock Exchange (ASX)-listed companies. The results, based on logistic regression analyses, indicated that risk management committees tend to exist in companies with an independent board chairman and larger boards. Further, the results also indicate that in comparison to companies with a combined risk management committee and audit committee, those with a separate risk management committee are more likely to have larger boards, higher financial reporting risk and lower organisational complexity. This study shows that indeed corporate governance is important in risk management of organisations.

A study by Sarens and Christopher (2010) sought to investigate whether the weaker focus on risk management and internal control within the Belgian corporate governance
guidelines is associated with less developed risk management and internal control systems within Belgian companies, when compared to Australian companies. Theoretical arguments were drawn from institutional theory. Data for the study were collected through a questionnaire that was sent out to chief audit executives in Australia and Belgium. The study found that the weaker focus of the Belgian corporate governance guidelines on risk management and internal control is associated with less developed risk management and internal control systems in Belgian companies than in Australian companies. The findings contribute to the literature on corporate governance, as they suggest that the specific content of corporate governance guidelines is an important variable to take into account. This paper also confirms that institutional theory is a relevant framework to study on the one hand, corporate governance practices in a "comply or explain" context, and on the other hand, corporate governance practices within unlisted companies.

A conceptual paper by Brown, Steen and Foreman (2009) sought to identify and discuss the relationship between corporate governance and risk management of high technology firms, with publicly listed Australian biotechnology companies as a case in point. The authors presented a governance structure that better manages the numerous complex risks such companies face. In their findings, they asserted that audit committees are traditionally responsible for oversight of auditing matters relating to the company’s financial systems and risk management relating to financial reporting. While the audit committee needs to have a full understanding of the risk management system in order to be able to assess the overall risk profile of the company, the authors illustrate that the complex risk and regulatory environment high technology firms face may necessitate the
creation of a separate risk management committee to interface with and assist the board and audit committee (Brown et al., 2009).

Kleffner, Lee and McGannon (2003) examined the use of enterprise risk management (ERM) by companies in Canada, the characteristics that are associated with the use of enterprise risk management, what obstacles companies face in implementing enterprise risk management, and what role, if any, corporate governance guidelines have played in the decision to adopt enterprise risk management. Kleffner et al., (2003) obtained data from the responses to a mail survey sent to Canadian Risk and Insurance Management Society members as well as telephone interviews with 19 of the respondents. The results indicated that 31 percent of the sample had adopted enterprise risk management and that reasons for adopting enterprise risk management include the influence of the risk manager (61 percent), encouragement from the board of directors (51 percent), and compliance with Toronto Stock Exchange (TSE) guidelines (37 percent). The major deterrents to enterprise risk management were an organizational structure that discourages enterprise risk management and an overall resistance to change. Although only about one-third of companies indicated that they had adopted an enterprise risk management approach, evidence was clear that a larger portion of the sample was moving in that direction, as indicated by what changes they had observed in their companies in the past three years. These included the development of company-wide guidelines for risk management (45 percent), an increased awareness of nonoperational risks by operational risk management personnel and an increased awareness of operational risks by nonoperational risk management personnel (49 percent), more coordination with different areas responsible for risk management (64 percent), and more involvement and interaction in the decision making of other departments. Contrary to what the researcher had expected, there was not
a significant difference between firms that were listed on the TSE versus those that were not in terms of the propensity to use enterprise risk management. It can be noted that the fact that 37 percent of firms indicated that the TSE guidelines were influential in their decision to adopt enterprise risk management provides some evidence that the guidelines are influencing companies’ risk management strategies.

2.6 Summary of Literature Review

The chapter has attempted to exhaustively review literature on risk management and the role of corporate governance in risk management. In summary, corporate governance procedures have been instrumental in establishing better enterprise risk management practices for various companies.

In such much as there is a lot of literature on risk management and also on corporate governance, there is little on the role of corporate governance on risk management. The available empirical studies on the same have been done on a different business environment from the Kenyan one hence the results cannot be generalised to Kenya. This constitutes a gap in literature that the present study seeks to bridge.

The next chapter is the methodology and presents the way in which this study will be carried out in order to fulfil the study objective.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methodology. The research design is outlined followed by the population, data collection and data analysis.

3.2 Research Design

The present study used a cross-sectional survey design. The cross-sectional design is the most commonly used when the researcher seeks to collect cross-sectional data at one point in time (Mugenda and Mugenda, 2003). This method is selected because the researcher sought to collect data from a cross-section of banks at one point in time.

3.3 Population

The population of this study was all the commercial banks which had been operating in Kenya for at least five years. According to the Central Bank Supervision Report (2010) there were 44 licensed commercial banks operating in Kenya. This was a census survey of all the commercial banks.

3.4 Data Collection

Data was collected using primary and secondary sources. Data on risk management was collected through a questionnaire designed for the risk managers in each of the banks. Risk management (RM) was the dependent variable. This was measured on a five-point Likert response scale ranging from 1 (strongly disagree) to 5 (strongly agree). The questionnaire is attached as appendix 1. The secondary sources were the bank annual
statements. Corporate governance data was collected from the annual statements. The data sought was on board dimensions such as size (BOARD_SIZE), CEO duality (CEO_DUAL) and diversity (BOAD_DIV). The board dimensions were the focus of corporate governance.

3.5 Data Reliability and Validity

The data collected from the questionnaires were checked for reliability using the Cronbach’s alpha. The alpha coefficient was 0.72 hence suggesting data reliability. The Statistical Package for Social Sciences (SPSS) aided in the analysis of reliability and validity.

3.6 Data Analysis

Data was analysed using regression analysis. The following model was used:

\[ RM = \alpha + \beta_1(BOARD\_SIZE) + \beta_2(CEO\_DUAL) + \beta_3(BOARD\_DIV) + \text{error} \]

Where:

RM is measured by the mean score on risk management variables

BOARD_SIZE is measured by the number of board members

CEO_DUAL is measured by whether the CEO is also the chair of the board of directors. A value of 1 will be given if there is duality otherwise 0.

DIV is measured by the cognitive diversity of the board measured as a proxy the proportion of institutional administrators sitting at the boards of directors of banks.
4.1 Introduction

The study was designed with the aim of establishing the relationship between risk management practices and corporate governance among commercial banks in Kenya. To achieve this objective, data was collected from respondents drawn from the middle and top management in commercial banks in Kenya.

The study was undertaken at two levels. In the first level, data on risk management was collected through a questionnaire designed for the risk managers in each of the banks. The second level involved collection of corporate governance data from the annual statements. The data sought was on board dimensions such as size (BOARD_SIZE), CEO duality (CEO_DUAL) and diversity (BOAD_DIV).

This chapter presents the results of the study. The study targeted 44 banks. Thus, a total of 44 questionnaires were distributed to the respondents in the 44 banks. Of these, 22 questionnaires were successfully completed and returned to the researcher by respondents, giving a response rate of 50%, a figure considered substantially sufficient for the study. The chapter is organised as follows: first, the chapter presents the results on the profiles of respondents. This is followed by results on corporate governance practices. Then, a presentation of risk management practices follow. Lastly, a presentation on the relationship between corporate governance and risk management practices is shown.
4.2 Characteristics of Respondents

This section presents the results of the profile of the respondents in terms of their gender, age, duration of stay in the organisations as well as the experience in their current positions. The results are shown in terms of frequencies and percentages. The questions relating to these analyses are in section A of the questionnaire.

An analysis of the gender of employees was performed with a view of presenting the composition of respondents in terms of their sexes. The results are shown in Table 1.

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>15</td>
<td>68</td>
</tr>
<tr>
<td>Female</td>
<td>7</td>
<td>32</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>22</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Research Data

The study found that 68% of the respondents were male while 32% were female. These results show that most of the managers in these firms were male. This mirrors the composition of managers in manufacturing firms based on gender.

The ages of the respondents was also analysed in order to establish the composition of workforce in the organisations in terms of their age. These results are shown in Table 2.
The study found that 9% were aged 26-30 years, 14% were aged 31-35 years, 27% were aged 36-40 years, 32% were aged 41-45 years, and 18% were aged 46-50 years. These results indicate that most of the managers were in their forties. This shows that the workforce was young and vibrant.

The results on the analysis of how long the managers had been working in the firms are shown in Table 3.

The study found that 9% of the managers had been working in the firms for up to 2 years, 32% for a period of 3 to 5 years, 14% for 6 to 10 years and 45% for over 10 years. The results show that most of the managers had over 10 years experience in the firms.
This shows that they had been working long enough to understand the dynamics of their respective organisations.

The experience of the managers in their current roles was also analyzed and the results are shown in Table 4.

### Table 4: Experience in current positions

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 2 years</td>
<td>4</td>
<td>18</td>
</tr>
<tr>
<td>3 to 5 years</td>
<td>8</td>
<td>36</td>
</tr>
<tr>
<td>6 to 10 years</td>
<td>10</td>
<td>46</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>22</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Research Data

The study found that 18% had up to 2 years experience, 36% had 3 to 5 years experience while 46% had 6 to 10 years experience. The results show that most of the managers had a 6-10 year experience in their present management positions.

### 4.2 Corporate Governance Practices of Commercial Banks

This section presents the results of corporate governance practices of commercial banks in Kenya. The descriptive results in Table 5 are presented based on minimum, maximum, mean, and standard deviations.
Table 5: Descriptive Statistics of Explanatory Variables

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>RM</td>
<td>22</td>
<td>2.34</td>
<td>4.75</td>
<td>3.048</td>
<td>.05852</td>
</tr>
<tr>
<td>Board Size</td>
<td>22</td>
<td>6.00</td>
<td>13.00</td>
<td>9.545</td>
<td>1.8702</td>
</tr>
<tr>
<td>CEO Duality</td>
<td>22</td>
<td>.00</td>
<td>1.00</td>
<td>.0909</td>
<td>.29424</td>
</tr>
<tr>
<td>Cognitive diversity</td>
<td>22</td>
<td>.00</td>
<td>1.00</td>
<td>.7273</td>
<td>.45584</td>
</tr>
</tbody>
</table>

Source: Research Data

As shown in Table 5, risk management (RM) had a minimum value of 2.34 and a maximum value of 4.75. The results show that the highest risk management was at 4.75 which are considered very high. The mean RM was 3.048 which indicate that the practice was moderate in the industry. The standard deviation of 0.05852 also shows that the variance of risk management was low.

Board size was measured by the number of members sitting on the board of directors. It can be noted from Table 5 that the minimum number of board members was 6 while the maximum number was 13. The average number of board members for the banks surveyed was 9.5455 which mean that most of the banks had an average of 9 members. The standard deviation was 1.87 suggesting a variance of about 2 people on bank board of directors.

CEO duality measured whether the CEO was also the chairman of the board. The study used a dichotomic variable where the value of 1 was used in case of duality and the value of 0 if the two functions were separate. Table 5 shows that the minimum was 0 and maximum was 1. The mean was 0.909 which suggests that most of the banks did not have
duality as a problem. The standard deviation of 0.29 also suggests very low variance from the mean duality value.

Cognitive diversity was measured on the grounds of whether an institutional shareholder also sat on the board. A dichotomic variable of 1 was allocated if an institutional shareholder sat on the board and 0 otherwise. Table 5 reveals that the minimum was 0 and maximum was 1. The mean was 0.7273 meaning that the banks tended to have institutional board members on their boards. The standard deviation was 0.45584 suggesting that the deviation of the mean was average.

4.3 Risk Management Practices of Banks in Kenya

This section presents the results on risk management practices of commercial banks in Kenya. The responses were made on a five-point likert scale. The results are interpreted in terms of mean scores and standard deviations. Mean scores of more than 3 shows that the method was commonly used or managed but the mean score below 3 shows that the method was least used or managed. Table 6 shows the analysis on the extent to which risks are managed in commercial banks in Kenya.

Table 6: Types of managed risks

<table>
<thead>
<tr>
<th>Types of managed risks</th>
<th>Mean</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency risk</td>
<td>4.2222</td>
<td>.79682</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>4.1111</td>
<td>1.00791</td>
</tr>
<tr>
<td>Commodity price risk</td>
<td>1.7778</td>
<td>.79682</td>
</tr>
<tr>
<td>Equity price risk</td>
<td>3.4444</td>
<td>1.36161</td>
</tr>
</tbody>
</table>

Source: Research Data
The study found that the most managed risk in the banking sector was foreign currency risk (4.22). This is followed by interest rate risk (4.11) and equity price risk (3.44). The least managed risk was commodity price risk (1.78).

The respondents were asked to state the extent to which the firms used various instruments to manage currency risks. The results are shown in Table 7.

Table 7: Management of currency risks

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structured derivatives</td>
<td>3.1111</td>
<td>1.11555</td>
</tr>
<tr>
<td>Over-the-counter currency option</td>
<td>2.0000</td>
<td>.95618</td>
</tr>
<tr>
<td>Stock exchange currency option</td>
<td>2.6667</td>
<td>1.17108</td>
</tr>
<tr>
<td>Currency swap</td>
<td>3.6667</td>
<td>1.26491</td>
</tr>
<tr>
<td>Currency futures</td>
<td>2.4444</td>
<td>1.36161</td>
</tr>
<tr>
<td>Currency forward</td>
<td>3.3333</td>
<td>1.58565</td>
</tr>
</tbody>
</table>

Source: Research Data

The study found that currency risk management tools were currency swaps (3.67), currency forwards (3.33) and structured derivatives (3.11). The least used method was over-the-counter currency option (2.00).

The results in Table 8 show the extent to which the banks used various instruments to manage interest rate risks.
Table 8: Management of interest rate risks

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structured derivatives</td>
<td>4.2222</td>
<td>.79682</td>
</tr>
<tr>
<td>Over-the-counter currency option</td>
<td>2.1111</td>
<td>1.38930</td>
</tr>
<tr>
<td>Stock exchange currency option</td>
<td>2.6667</td>
<td>1.26491</td>
</tr>
<tr>
<td>Currency swap</td>
<td>1.2222</td>
<td>.42164</td>
</tr>
<tr>
<td>Currency futures</td>
<td>2.0000</td>
<td>.82808</td>
</tr>
<tr>
<td>Currency forward</td>
<td>3.2222</td>
<td>1.24467</td>
</tr>
</tbody>
</table>

Source: Research Data

The study found that the most used instruments to manage interest rate risks were structured derivatives (4.22) and currency forward (3.22). The least used methods were currency swaps (1.22) and currency futures (2.00).

The respondents were asked to state the extent to which the firms used various instruments to manage commodity price risks. The results are shown in Table 9.

Table 9: Management of commodity price risks

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structured derivatives</td>
<td>4.2222</td>
<td>.79682</td>
</tr>
<tr>
<td>Over-the-counter currency option</td>
<td>2.1111</td>
<td>1.38930</td>
</tr>
<tr>
<td>Stock exchange currency option</td>
<td>2.6667</td>
<td>1.26491</td>
</tr>
<tr>
<td>Currency swap</td>
<td>1.2222</td>
<td>.42164</td>
</tr>
<tr>
<td>Currency futures</td>
<td>2.0000</td>
<td>.82808</td>
</tr>
<tr>
<td>Currency forward</td>
<td>3.2222</td>
<td>1.24467</td>
</tr>
</tbody>
</table>

Source: Research Data

The results revealed that the most used methods to manage commodity price risks were structured derivatives (4.22) and currency forward (3.22). The least used method was currency swap (1.22).
4.4 Corporate Governance and Risk Management

In order to test for the relationship between corporate governance and risk management, a regression analysis was performed. This was aided by the following regression model:

\[ RM = \alpha + \beta_1(BOARDSIZE) + \beta_2(CEODUAL) + \beta_3(DIV) + \varepsilon \]

The results of the analysis are shown in Table 10 and Table 11.

Table 10: Relationship between Corporate Governance and Risk Management

<table>
<thead>
<tr>
<th></th>
<th>R</th>
<th>R²</th>
<th>Adjusted R²</th>
<th>SE of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>.754</td>
<td>.569</td>
<td>.521</td>
<td>.00127</td>
</tr>
</tbody>
</table>

Source: Research Data

Table 10 shows that the Pearson correlation coefficient, R, was 0.754. This means that there was a high positive correlation between corporate governance and risk management. The \(R^2\) shows that corporate governance influenced 56.9% of the variance in risk management. The adjusted \(R^2\) reveals that the influence of corporate governance on risk management was 52.1%. It reveals that better corporate governance leads to a rise in risk management practice. This means that when good corporate governance mechanisms are upheld, the risk management of banks tend to increase by up to 56.9% (\(R^2 = 0.569\)). The standard error of estimate was 0.00127 which is considered very low. The variable coefficients are shown in Table 11.
Table 11: Variable Coefficients

<table>
<thead>
<tr>
<th></th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
</tr>
<tr>
<td>Constant</td>
<td>.437</td>
<td>.258</td>
</tr>
<tr>
<td>Board size</td>
<td>.904</td>
<td>.009</td>
</tr>
<tr>
<td>CEO duality</td>
<td>-.010</td>
<td>.057</td>
</tr>
<tr>
<td>Cognitive diversity</td>
<td>.701</td>
<td>.037</td>
</tr>
</tbody>
</table>

Source: Research Data

Table 11 reveals that the constants alpha and error terms were 0.437 and 0.258 respectively. The beta values for board size and cognitive diversity suggest that they had a positive influence on risk management. Thus, the larger the board size, the higher is the risk management and the more the institutional investors sitting on the board, the risk management practice. CEO duality had a negative influence on risk management. Thus, risk management tends to decline if the CEOs also double up as chairmen of the board of directors – duality. All these correlations were highly significant (p<0.05).

4.5 Discussion of Findings

The study found that the level of corporate governance was moderate as shown by the mean score of 3.048. This coincides with most studies in developing countries on the state of corporate governance practices in Africa (Barako and Alistair, 2008). Most of the developing nations such as Kenya are still in the infant processes of entrenching corporate governance mechanisms hence the reason for moderate values for the practice in financial institutions in Kenya.
On the level of risk management among commercial banks in Kenya, the study noted that indeed the management of risks was high. This confirms the previous studies in Kenya on risk management especially Kioko (2008) and Kipchirchir (2008) on the risk management in commercial banks in Kenya. This high practice is attributed to the growing regulatory framework in Kenya on risk management of financial institutions.

The study also noted a high significant positive correlation between risk management and corporate governance. This is consistent with Subramaniam et al (2009), Sarens and Christopher (2010) and Kleffner et al. (2003). Thus, it is important for financial institutions to maintain high corporate governance levels in order to effectively translate to better risk management practice.
CHAPTER FIVE
SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

5.1 Introduction
This chapter presents the summary of research findings, conclusion of the study, recommendations for policy and practice, limitations of the study, and suggestions for further research.

5.2 Summary
The objective of this study was to establish the relationship between corporate governance and risk management practices of commercial banks in Kenya. The study found that 68% of the respondents were male while 32% were female. The study found that 9% were aged 26-30 years, 14% were aged 31-35 years, 27% were aged 36-40 years, 32% were aged 41-45 years, and 18% were aged 46-50 years. The study found that 9% of the managers had been working in the firms for up to 2 years, 32% for a period of 3 to 5 years, 14% for 6 to 10 years and 45% for over 10 years. The findings further revealed that 18% had up to 2 years experience, 36% had 3 to 5 years experience while 46% had 6 to 10 years experience.

The level of corporate governance was found to be moderate as shown by the mean score of 3.048. The average number of board members for the banks surveyed was 9.5455 which mean that most of the banks had an average of 9 members. The mean score for CEO duality was 0.909 which suggests that most of the banks did not have duality as a problem. The mean for cognitive diversity was 0.7273 meaning that the banks tended to have institutional board members on their boards.
On the level of risk management among commercial banks in Kenya, the study noted that indeed the management of risks was high. The study found that the most managed risk in the banking sector was foreign currency risk (4.22). This is followed by interest rate risk (4.11) and equity price risk (3.44). The least managed risk was commodity price risk (1.78).

The study also noted a high significant positive correlation between risk management and corporate governance ($R = 0.754, p<0.05$). The beta values for board size and cognitive diversity suggest that they had a positive influence on risk management (Beta = 0.904 and 0.701 respectively). CEO duality had a negative influence on risk management (Beta = -0.010).

5.3 Conclusions

The study concludes that corporate governance is moderate in the banking industry in Kenya. This is attributed to the overall slow corporate governance evolution in Kenya that is slowly catching up in the financial sector due to the high regulatory oversight of central banks in the world due to recent financial scandals as well as the global financial crisis.

It is concluded that the extent of risk management in the banking industry was high. With the development of better tools to manage risks as well as Basel II and Basel III, there is currently more emphasis to manage risks in the financial sector in order to avoid future financial sector crises.
The study also concludes that there is a significant influence of corporate governance on risk management practices of commercial banks in Kenya. This is attributed to the fact that better corporate governance mechanisms lead to better management of risks.

5.4 Recommendations

The study recommends need for banks to entrench more measures to manage risks. This will help in ensuring that such risks are better managed for their gains to be realised in the future.

The study also recommends that the banks should also work on enhancing their corporate governance in terms of board characteristics. This can also be enhanced by putting into place better corporate governance practices.

5.5 Limitations of the Study

There were a number of limitations that affected the outcome of the study. For instance, data was collected from only 22 firms out of the total number of 44 firms. This is because most of the banks were not willing to give out the information regarding their activities.

The analysis covered only the commercial banks only. This may limit the applicability of the findings to the entire financial sector.

The other limitation was time factor as it was not possible to cover all the 44 commercial banks within the time given to carry out the research. These issues may limit the applicability of the research findings to the industry.
The other limitation of this study stems from the study design. The companies in the industry are used but the period covered is a point in time. Results may have been different if a longitudinal survey would have been carried out to establish the evolution of risk management and corporate governance over time.

Financial resources were another limitation. The research demanded a lot of printing, bindings, typesetting, and data collection. All these activities needed money and this was a challenge to the researcher.

5.6 Suggestions for Further Research

There is need to replicate these results to other sectors especially the manufacturing sector to establish whether significant contribution of corporate governance on risk management can be found.

Also, there is need for future studies to increase the sample firms. It would be prudent to cover at least the 40 banks in future studies.

Future studies should perform a longitudinal analysis to establish the evolution of corporate governance and risk management in the banks over time in Kenya.

More studies need to be done especially to determine a comparative analysis of the practice of corporate governance and risk management in financial institutions such as insurance companies or investment banks in Kenya.
There is need to establish the influence of corporate governance on corporate social reporting in Kenya.
REFERENCES


Appendix 1: Research Questionnaire

Section 1: General Information

1. State your gender.
   Male [ ]
   Female [ ]

2. State your age.
   18-25 years [ ]
   26-30 years [ ]
   31-35 years [ ]
   36-40 years [ ]
   41-45 years [ ]
   46-50 years [ ]
   51 or above [ ]
   Other (specify) [ ]

3. State your highest level of education?
   Primary [ ]
   Secondary [ ]
   College [ ]
   Bachelor’s degree [ ]
   Master’s degree [ ]
   Other (specify) [ ]
4. State your marital status.

Single [ ]
Married [ ]
Other (specify) [ ]

5. How long have you been working in the bank?

0 to 2 years [ ]
3 to 5 years [ ]
6-10 years [ ]
Over 10 years [ ]

6. What is your designation?

7. How long have you been working under your present position?

0 to 2 years [ ]
3 to 5 years [ ]
6-10 years [ ]
Over 10 years [ ]

Section 2: Risk Management Practices

8. What risks does the company manage? You can tick more than one option.

Foreign currency risk [ ]
Interest rate risk [ ]
Commodity price risk  [  ]
Equity price risk  [  ]

9. What currency risk management instruments does your company use? You can tick more than one option.

Structured derivatives  [  ]
Over-the-counter currency option  [  ]
Stock exchange currency option  [  ]
Currency swap  [  ]
Currency futures  [  ]
Currency forward  [  ]

10. What interest-rate risk management instruments does your company use? You can tick more than one option.

Structured derivatives  [  ]
Over-the-counter currency option  [  ]
Stock exchange currency option  [  ]
Currency swap  [  ]
Currency futures  [  ]
Currency forward  [  ]

11. What commodity price risk management instruments does your company use? You can tick more than one option.

Structured derivatives  [  ]
Over-the-counter currency option  [  ]
<table>
<thead>
<tr>
<th>Stock exchange currency option</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency swap</td>
<td>[ ]</td>
</tr>
<tr>
<td>Currency futures</td>
<td>[ ]</td>
</tr>
<tr>
<td>Currency forward</td>
<td>[ ]</td>
</tr>
</tbody>
</table>

Kindly mark in the appropriate box the extent to which you agree with the following statements as regards risk management in your organisation.

**Within our company:**

12. Responsibilities related to risk management are clearly defined and communicated.

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately disagree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Neutral</td>
<td>[ ]</td>
</tr>
<tr>
<td>Moderately agree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Strongly agree</td>
<td>[ ]</td>
</tr>
</tbody>
</table>

13. Formal risk assessments are performed regularly.

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately disagree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Neutral</td>
<td>[ ]</td>
</tr>
<tr>
<td>Moderately agree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Strongly agree</td>
<td>[ ]</td>
</tr>
</tbody>
</table>
14. A formal risk management system is used.

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately disagree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Neutral</td>
<td>[ ]</td>
</tr>
<tr>
<td>Moderately agree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Strongly agree</td>
<td>[ ]</td>
</tr>
</tbody>
</table>

15. Policies are formalised.

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately disagree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Neutral</td>
<td>[ ]</td>
</tr>
<tr>
<td>Moderately agree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Strongly agree</td>
<td>[ ]</td>
</tr>
</tbody>
</table>

16. Procedures are formalised.

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately disagree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Neutral</td>
<td>[ ]</td>
</tr>
<tr>
<td>Moderately agree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Strongly agree</td>
<td>[ ]</td>
</tr>
</tbody>
</table>

17. There is a high level of risk awareness at the management level

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>[ ]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately disagree</td>
<td>[ ]</td>
</tr>
<tr>
<td>Neutral</td>
<td>[ ]</td>
</tr>
</tbody>
</table>
18. There is a high level of risk awareness at lower levels.

Strongly disagree [ ]
Moderately disagree [ ]
Neutral [ ]
Moderately agree [ ]
Strongly agree [ ]

19. There is a separate risk manager or risk management function.

Strongly disagree [ ]
Moderately disagree [ ]
Neutral [ ]
Moderately agree [ ]
Strongly agree [ ]

End of Questionnaire