

**THE RELATIONSHIP BETWEEN CORPORATE
GOVERNANCE, OWNERSHIP STRUTURE AND FINANCIAL
PERFORMANCE OF INSURANCE COMPANIES IN KENYA**

BY

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the award of the Degree of Master of Business Administration (MBA), School of Business,
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DECLARATION

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

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DEDICATION

To Nkatha and Muriuki

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I wish to sincerely thank my family for their unending support in all ways while I pursued my education, my supervisor Mr. Mirie Mwangi for his constructive criticism and time. He guided me all through to bring this project to the shape it is in.

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Finally, to God be the glory, for the things He has done!

ABSTRACT

The study investigates into the relationship between ownership, corporate governance structures and financial performance of insurance companies. Corporate governance and ownership structures have been assumed to be some of the factors that may influence the financial performance of insurance companies in Kenya.

The study comprised of 41 licensed insurance companies and they were studied over a five year period from 2005 to 2009. The findings revealed that the average number of board members in Kenyan insurance companies was either 6 or 7 with non-executive directors being in the range of 5 and 6. Companies underwriting only life business however had fewer directors in the period between 2005 and 2007. Companies underwriting insurance business also had higher leverage compared to the composite underwriters. The average ownership concentration is 65%.

The governance variables studied showed a significant relationship between size, non executive directors and leverage with both Return on Assets (ROA) and Return on Equity (ROE). The results showed a positive return on assets however, when ownership was considered, the results became negative. The results further showed that board size and constitution and financial leverage have a significant impact on both return on equity and return on assets. The study also found that there was a significant relationship between size, outside (non-executive) directorships and leverage with both return on assets (ROA) and return on equity (ROE). The study also found that the relationship between ownership and financial performance of insurance companies was insignificant.

The study concluded with recommendations to the regulators to come up with benchmarks that can be adopted in the insurance industry to improve financial performance.

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ABBREVIATIONS

AKI	- Association of Kenya Insurers
BSE	- Bombay Stock Exchange
CEO	- Chief Executive Officer
CMA	- Capital Market Authorities
DW	- Durbin Watson
FY	- Financial Year
GDP	- Gross Domestic Product
IAIS	- International Association of Insurance Supervisors
ICPAK	- Institute of Certified Public Accountants of Kenya
IFC	- International Finance Corporation
IRA	- Insurance Regulatory Authority
IRRC	- International Responsibility Research Centre
MBV	- Market Book Value
MP	- Market Price
NSE	- Nairobi Stock Exchange
OECD	-Organisation for Economic Co-operation and Development
PHCF	-Policy Holders Compensation Fund
ROA	- Return on Assets
ROE	- Return on Equity

CHAPTER ONE

INTRODUCTION

1.1. BACKGROUND TO THE STUDY

1.1.1. Corporate Governance

Corporate governance is the system by which business corporations are directed and controlled. In a narrow sense, the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. In a broader sense, it delineates the rights and responsibilities of each primary stakeholder and the design of institutions and mechanisms that induce or control board directors and management to best serve the economic interests of shareholders (and other stakeholders) of a company. Many of these other stakeholders also play a role in monitoring the behaviour of the board/management (OECD, 1999; Kaur and Gill, 2008).

Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997). It lays out how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure/motivate the corporate managers to deliver a competitive rate of return (Mathiesen, 2002).

1.1.2. Ownership Structure

There are several forms of ownership structures known worldwide. They include a sole proprietorship, partnership, limited liability company, non-profit corporation and cooperatives. A limited liability company, the form under which most of the insurance companies in Kenya fall, is an entity that has a separate legal personality from its members. Corporate ownership can be by multiple shareholders whereby its running is overseen by a Board of Directors which hires

the business's managerial staff. A corporation can also be owned by the state. Ownership implies responsibility for actions regarding the property. A "legal shield" is said to exist if the entity's legal liabilities do not get redistributed among the entity's owners or members. An application of this, to limit ownership risks, is to form a new entity to purchase, own and operate each property. Since the entity is separate and distinct from others, if a problem occurs which leads to a massive liability, the individual is protected from losing more than the value of that one property (Kouwenberg, 2006).

Ownership of a company in any country is regulated by the government. In Kenya, the companies Act, Cap 486, defines the forms of corporate ownership. The Insurance Act, Cap 487 defines how ownership of insurance companies can be constituted. It states that; "Subject to section 23, no person shall be registered as an insurer under this Act unless that person is a body corporate incorporated under the Companies Act and at least one third of the controlling interest, whether in terms of shares, paid up share capital or voting rights, as the case may be, are held by citizens of Kenya or by partnership whose partners are all citizens of Kenya or by a corporate body whose shares are wholly owned by citizens of Kenya or is wholly owned by the Government. Out of the amount of the paid-up capital under subsection (1), not less than one third shall be owned by Kenya citizens or by a partnership whose partners are all citizens of Kenya or wholly owned by citizens of Kenya or is wholly owned by the Government" (Insurance Act, Cap 487).

1.1.3. Financial Performance

Financial performance is measuring the results of a firm's policies and operations in monetary terms. The results are reflected in the firm's return on investment, return on assets, value added e.t.c. It is also a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Financial performance of an organization is measured using indicators which are divided into three categories: profitability

(operating) ratios, which gauge a company's success over a given period of time; liquidity ratios, which measure the short-term ability of a company to pay its debt and meet expected cash needs; and solvency ratios, which indicate a company's ability to meet long-term commitments on a continuing basis (Downes and Goodman, 2003).

1.1.4 Performance and Ownership

The fundamental insights into the issues of ownership and performance date back to Berle and Means (1932), who argue that the separation of ownership and control of modern corporations naturally reduces management incentives to maximise corporate efficiency. Their concerns were later developed by Jensen and Meckling (1976) into what has subsequently come to be known as the 'agency theory' which has been characterised as 'the theory of corporate ownership structure' and guiding framework for ownership-performance studies. Ownership structure is often thought of as an important instrument to resolve the conflict of interests between shareholders and managers.

The relationship between corporate performance and ownership can be divided into two streams, one concerning the efficacy of concentration of ownership; and the other revealing the distinctive motivations, abilities, and effectiveness of managerial ownership to influence corporate value. It is widely accepted that ownership concentration has the potential to limit the agency problem, and then generate positive improved corporate performance. Adenikinju and Ayorinde (2003) define ownership concentration as the proportion of shares held by the top 10 shareholders. Firms are different in terms of ownership mix and concentration. The resultant distribution of ownership among different groups can impact on managerial opportunism, which subsequently has implications for managerial behaviours and corporate performance (Kihara, 2004). Grossman and Hart (1986) illustrate how this effect is explained by efficient monitoring hypothesis which contends that higher concentration of ownership gives large shareholders stronger incentives and greater power at lower cost to monitor management. Shareholders with a larger stake in the company show more willingness to play an active role in corporate decisions because partially they internalize the benefits from their monitoring effect. Shleifer and Vishny

(1997) however note that even when shareholders cannot monitor the management themselves, large shareholders can facilitate third party takeovers by splitting gains on their own shares with the bidder.

Some shareholders are entirely passive investors, whereas others are more active and do perform an important monitoring service. Various motivations and abilities of different types of shareholders may result in their distinctive effectiveness to influence major corporate decisions and value. Jensen and Meckling (1976) formalise the relationship between managerial ownership and value when they propose the convergence-of-interest hypothesis to explain the positive effect of managerial ownership. Sufficiently high level of managerial ownership helps align the interests of managers and shareholders resulting in superior performance. A high level of managerial ownership increases the probability that the manager devotes significant effort to creative activities and immunizes himself from misappropriating corporate resources. Since Jensen and Meckling (1976), ownership has been supposed to be a determinant of corporate performance i.e. causality runs from ownership to performance.

1.1.5 Performance and Governance

Kouwenberg (2006) states that good governance means little expropriation of corporate resources by managers or controlling shareholders, which contributes to better allocation of resources and better performance. As investors and lenders will be more willing to put their money in firms with good governance, they will face lower costs of capital, another source of better firm performance. Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and longer lasting than those with firms with less effective governance.

Poor corporate governance is often associated with diffuse ownership, poor regulatory control, and a legal system that is not able or willing to protect shareholder rights. Better corporate governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision making. Less expropriation of minority

shareholders and fewer corruptive links between big businesses and political power may result in a more favourable business environment for smaller enterprises and more equitable income distribution.

The agency theory says that better corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased. However, as Gompers, Ishii, and Metrick (2001) suggest, the evidence of a positive association between corporate governance and firm performance may have little to do with the agency explanation. In connection with the relationship between corporate governance and firm value, the most studied governance practices include board composition and size and takeover defences.

Shleifer and Vishny (1997) also argue that corporate governance can explain the performance of firms. In developed countries, the governance system is relatively efficient in that investors are confident to obtain returns on their investment and firms can raise the necessary funds to finance their investment projects. In contrast governance mechanisms in developing countries are generally weak and the risk of expropriation of shareholders by managers or block holders is considerable (Kihara, 2004).

1.1.6 Empirical Evidence

According to a survey by McKinsey & Company (2002), 78% of professional investors in Asia said that they were willing to pay a premium for a well-governed company. The average premium these investors were willing to pay generally ranged from 20% to 25%. In Continental Europe and East Asian economies, studies suggest that block ownership per se might often have a positive effect on firm performance for better monitoring, (Xu and Wang, 1999)

The empirical investigations in developing economies are more concerned with the overall quality of corporate governance rather than with any particular practices or features of such governance. Kihara (2004) studied 36 companies listed in the Nairobi stock Exchange over a period of five years from 1999 to 2004. The results also showed that there is no relationship

between state, institution and individual ownership and performance of firms listed at the NSE. However, the performance of firms dominated by foreign investors seems to be much higher than that of firms dominated by any other group of investors.

Oltetia (2002) carried out a research on ownership and performance of companies listed in the Nairobi Stock Exchange and observed that, institutional investors and foreign investors were two dominant groups of investors controlling on average 41% and 34% ownership respectively. The state and individuals hold minority shares in listed companies. He also concluded that there was inefficiency related to state, institutional and individual ownership. He found out that the influence of the state as a shareholder, institution and individual shareholders to firms' profitability is insignificant, if not completely irrelevant. However, it was found that foreign investors have a significant impact on firms' profitability but only when taken as a group.

1.1.7 The Kenyan Context

There is little information on studies done to establish the relationship between ownership, governance and performance of the insurance sector in Kenya. A study by the centre for corporate governance in 2004, found that there was very minimal disclosure and financial reporting in the insurance industry. Aholi (2004) identified many shortcomings in disclosures, consistency and accuracy in the reporting of financial information of the insurance companies in his compliance review of the 2003 financial statements of insurance companies. These findings together with the collapse of insurance companies such as the United Insurance Company, Standard Assurance Company among others shows that there is need to establish effective corporate governance structures.

Naibo (2006) found that the shareholding in the insurance sector is not diverse. There was high concentration of ownership which followed that influence is exercised by few shareholders and directors. Due to this concentration, shareholder rights are protected through appointment of directors who direct and control the companies. Naibo (2006) also established that up to 73.3% of all companies in the Kenyan insurance sectors had established audit committees which have

charters and majority of the members are independent non executive directors and at least one member of ICPAK.

The Insurance Regulatory Authority, which is the industry regulator, plays a critical role in setting governance standards for the industry in Kenya Companies listed in the Nairobi stock exchange observe additional standards as outlined by the Capital Markets Authority. Companies that are seen to be performing better on the bourse attract more investors and subsequently the share price increases. Cases of hostile takeover have not been witnessed in companies that are performing poorly. However, government intervention has been useful to protect shareholders in cases of apparent misuse of funds.

Ownership is guided by the Companies Act Cap 486 and the Act specific to that industry. The custodian of governance in the Kenyan insurance sector is the Insurance Regulatory Authority. In Kenya, insurance is marked as one of the key players in the achievement of Vision 2030. However, currently it only contributes 2.63% to the Gross Domestic Product (GDP). According to the AKI Annual Report (2008), the insurance sector has had instances in the past with companies such as United Insurance, Standard Assurance, and Lakestar Insurance among others being put under receivership. However, the industry registered positive growth in 2008 with the gross written premium being Kshs 55.19 billion compared to Kshs 48.09 billion in 2007 representing a growth of 14.8%. The gross written premium in general insurance was Kshs 36.89 billion (2007: Kshs 32.95 billion) while that from long term business was Kshs 18.30billion (2007: Kshs 15.14 billion). General insurance premium grew by 12% while life insurance premium and contributions from deposit administration business grew by 20.9%. With a market penetration of 2.63%, there is a lot of room for improvement. Mechanisms such as good corporate governance and concentrated ownership can be applied to improve the confidence of the public towards the industry.

1.2. STATEMENT OF THE PROBLEM

Several studies have been carried out on the relationship between ownership structure and firm's performance with varying findings. Ownership has important implications for corporate strategy

for example investment decisions, take over, compensation schemes, management successions, dividend policy, and long and short-term orientation of managers, which in turn, influence corporate performance. Grossman and Hart (1980) showed that if a firm's ownership is widely dispersed, no shareholder has adequate incentives to monitor the management closely as the gain from a takeover for any individual shareholder is too small to cover the monitoring costs which will lower a firm's performance. Fama and Jensen (1983) argued that a more concentrated ownership structure will minimize the agency problem by aligning the interests of the residual claimants and the managers, and hence lead to a firm's improved performance. Berle and Means (1932) carried out a research and they suggested that an inverse correlation should be observed between the diffuseness of shareholdings and firm performance. Further, the benefits of concentrated ownership are that it brings more effective monitoring of management and helps to overcome agency problems thus improving performance of an organisation. Demsetz (1983) contrasted this view and argued that the ownership structure of a corporation should be thought of as an endogenous outcome of decisions that reflect the influence of shareholders and of trading on the market. Glassman and Rhoades (1980) compared financial institutions controlled by their owners with those controlled by managers and found that the owner-controlled institutions had higher earnings.

The corporate governance issues have received considerable attention because of their apparent importance for the economic health of companies especially after plethora of corporate scams in the recent times. One argument to prevent corporate failures is the strengthening of governance mechanism which could lead to improved firm's performance. By helping to promote firm performance and the protection of stake holder's interests, corporate governance encourages investment which is associated with macroeconomic growth. Nam *et al* (2005) established that corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased. Brown *et al* (2003) conducted a research on many major American companies and found that firms with weaker corporate governance perform poorly compared to those with stronger corporate governance in terms of stock returns, profitability, riskiness and dividend payment.

While research has been carried out on this topic, focus has not been on the emerging markets. The cross-national differences in corporate governance environments influence the performance of companies in the particular markets. The ownership-performance relationship varies across countries and over time. A particular ownership structure that is valuable for one economy may have no impact on another, making it difficult to pick up a definite relation. Thus, it is well worth contextualizing governance, ownership, and performance relation within a more comprehensive perspective. Corporate governance and performance relationship is mainly influenced by the realities of the environment within which the organization is operating (Hu & Izumida, 2008). In advanced economies, the shareholders are more aware of their rights and even the governments have strong investor protection mechanisms. That explains why corporate governance and ownership problems are arguably more serious and important in transitional and emerging economies. Given the differences in literature and the different operating environments, it is therefore a research question whether ownership structure and governance structure have any relationship with the performance of insurance companies.

The research will seek to answer the question, what is the relationship between ownership structures, governance structures and financial performance of insurance companies?

1.3. OBJECTIVE OF THE STUDY

The objective of the study is as follows:

To determine whether there is a relationship between the corporate governance, ownership structures and financial performance of insurance companies in Kenya.

1.4. SIGNIFICANCE OF THE STUDY

This study will be important to the following group of users

Investors

It will give an indication of what aspects of ownership and governance structure would have an impact on their financial performance. Investors will also be able to benefit from this research because they can predict the continued performance of the insurance companies measuring against the corporate governance practices and ownership.

The company owners will also be able to use this report to optimise their returns. This could be in terms of increased profit after tax, gross written premiums e.t.c. Subsequently, their company valuations will be higher and they can attract cheaper funds, more investors and give higher returns to the already existing investors.

Regulators and Policy Makers

Regulators and policy makers who may wish to incorporate findings of the research as they formulate legislation and policy on ownership structure and governance structure of insurance companies in Kenya. To the government, this will help enhance the efforts towards achievement of vision 2030. A performing insurance industry will raise the confidence of the public hence attract more business and subsequently increase the business underwritten in the companies. This will definitely increase the insurance industry's contribution to the GDP.

This study will be useful to the regulator in the industry by helping develop legal and regulatory frameworks. If adopted, it will help to consolidate gains made in the insurance industry by integrating good governance with ownership to improve performance.

Academicians

It will fill in a gap of knowledge and lay a foundation for further research. The academicians can develop it further to study the areas that may not have been covered in this research. These could be for example, studying the optimal corporate governance framework for the Kenyan insurance sector.

CHAPTER TWO

LITERATURE REVIEW

2.1 THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND PERFORMANCE

Corporate governance refers to the structures and processes for the direction and control of companies. It is concerned with the relationships among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. Improved governance structures and processes help ensure quality decision-making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance (IFC, 2002).

According to the International Association of Insurance Supervisors (IAIS), corporate governance refers to the manner in which boards of directors and senior management oversee the insurers' business. It encompasses the means by which members of the board and senior management are held responsible for their actions. Corporate governance includes corporate discipline, transparency, accountability, responsibility, fairness and social responsibility. Timely and accurate disclosure on all material matters regarding the insurer, including financial situation, performance, ownership and governance arrangements. It also includes legal and regulatory frameworks (IAIS, 2003).

The need for corporate governance exists because of the agency problem incurred by the separation of the capital providers and management. When it fails to enforce the contract between capital providers and managers, there has to be other mechanisms to ensure the efficiency of capital allocation in the economy. Corporate governance too affects the development and functioning of capital markets and exerts a strong influence on resource allocation. In an era of increasing capital mobility and globalization, it has also become an important

framework condition affecting the industrial competitiveness and economies of countries (Kouwenberg, 2006).

Good governance is necessary as it enables the organization to attract investors create competitive and efficient companies and business enterprises, enhance the accountability and performance of those entrusted to manage corporations and promote efficient and effective use of limited resources. Good governance is therefore a prerequisite for national economic growth. Corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased. Poor corporate governance on the other hand is fertile soil for corruption and corruptive symbiosis between business and political circles (Nam *et al*, 2005). Firms with weaker corporate governance perform poorly compared to those with stronger corporate governance in terms of stock returns, profitability, riskiness and dividend payment (Brown *et al*, 2003). Corporate governance should lead to higher stock prices or better long-term performance.

The concept of corporate governance has been a priority on the policy agenda in the developed market economies especially among very large firms. The concept is warming itself in the African continent. Indeed it is believed that the Asian crisis and the relative poor performance of the corporate sector in Africa have made the issue of corporate governance a catchphrase in the development debate. Recent studies show that good corporate governance increases valuations and boosts the bottom line. For example a study by Gompers *et al* (2003) showed that companies with strong shareholder rights yielded annual returns that were 8.5% greater than those with weak rights. Poorly governed firms are expected to be less profitable, have more bankruptcy risks, lower valuations and pay out less to their shareholders, while well-governed firms are expected to have higher profits, less bankruptcy risks, higher valuations and pay out more cash to their shareholders. Claessens (2003) also argues that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders. The position has stated that, weak corporate governance does not only lead to poor firm performance and risky financing patterns, but are also conducive to macroeconomic crises like the 1997 East Asia crisis. Other researchers

contend that good governance is important for increasing investor confidence and market liquidity. The main characteristic of corporate governance identified in studies on governance and performance are board size, board composition, and whether the CEO is also the board chairman (Kyereboah-Coleman and Biekpe, 2005).

It is however impossible to discuss corporate governance without making reference to the agency theory. Jensen and Meckling (1976) defined the agency relationship as a contract under which one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. Millions of people entrust their wealth in the hands of their personal wealth to the care of managers on the basis of a complex set of contracting relationships which delineates the rights of the parties involved. Agency costs are subsequently incurred in order to monitor the activities of the managers. A firm that is well governed will increase investor trust that might perceive it as less risky and apply a lower expected rate of return which leads to a higher firm valuation. Better governed firms might have more efficient operations, resulting in higher expected future cash flow stream (Bauer, *et al*, 2003).

The focus of attention in governance has been on the relationship between directors and management, with particular emphasis on the boards. This is understandable given the significance of their role in brokering power within and between different actors in governance. Of particular interest is the relationship between the boards and shareholders. This is critical as it undermines the efficiency in governance of the organisations. Transparency and accountability, which rests at the heart of good governance, are essentially missing in this relationship, as there is lack of information flow between them (Kihara, 2006).

OECD has played a major role in the development of corporate governance benchmarks. It first published the corporate governance principles in 1999 and they were revised in 2004. The principles provide guidance on the following:

1. Ensuring the basis for an effective corporate governance framework. The framework should promote transparent and efficient markets, be consistent with the rule of law and

clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

2. The rights of shareholders and key ownership functions. The corporate governance framework should protect and facilitate the exercise of shareholder rights.
3. The equitable treatment of shareholders: the framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
4. The role of stakeholders in corporate governance. The framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and shareholders in creating wealth.
5. Disclosure and transparency: the framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.
6. The responsibilities of the board: the framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

2.1.1 Corporate Governance and the Insurance Industry

Corporate governance in the insurance industry must address a wide range of issues within an insurance company, including who will run the insurance company, what will be the makeup of the Board of Directors, how will the board carry out its oversight of management officials, and what financial incentives and other factors will be used to align the actions of all these key players with that of stockholders in order to realise positive performance. With regard to who will run the insurance company, the management or top officers might be composed of the principal owners or be hired from outside this ownership group. While many insurance companies begin operations with major stockholders serving in management positions, a manager might be hired from outside if the owners do not have the background or the experience

to run the daily operations of the company or have other business interests occupying much of their time. Hiring a manager might also be the best option when the principal owners retire from management positions and no other insiders or family members are in a position to manage the company. Professional or hired managers may further provide a means for stockholders to bring in someone with the needed expertise, experience and outside perspective to run the insurance company well (Spong and Sullivan, 2007).

From a governance perspective, managers with significant stockholdings may differ notably from hired managers in their motivations and financial incentives. Owner managers will not only benefit financially from their salaries in running the company, but, as stockholders, will also be rewarded for good performance through their claim to insurance company earnings and capital appreciation. Hired managers with little or no stockholdings, on the other hand, will have their principal compensation coming through their salary. Consequently, hired managers will not have the same incentive to maximize the value of the stockholder's investment, and a hired manager's behaviour may therefore fail to serve the interests of the insurance company's owners. Since hired managers won't receive the same equity returns that owner managers would, a hired manager may not be motivated to put forth as much effort (shirking) as an owner manager. A hired manager might also attempt to maximize his or her utility by seeking to expand the firm beyond a profitable level (empire building), playing it safe and avoiding projects that stockholders and owner managers would be willing to pursue (risk aversion), and taking advantage of his or her position by consuming excessive perquisites (expense preference). All of these behaviours would benefit the hired manager at the expense of stockholders, and this inherent divergence in interests is the source of principal-agent problems (Jensen and Meckling, 1976).

2.1.2 Corporate Governance Mechanisms

Various academic studies suggest that managers have enormous discretion about firms' decisions and may not act in the best interests of the owners. In order to put a check on their activities, certain corporate governance structures are required to be in place. They include:

2.1.2.1 Composition of Board members

The composition of board members is proposed to help reduce the agency problem (Weisbach, 1988; Hermalin and Weisbach, 1991). A positive relationship is expected between firm performance and the proportion of outside director's sitting on the board. Unlike inside directors, outside directors are better able to challenge the CEOs. It is perhaps in recognition of the role of outside directors that a minimum of three outside directors is required on the board.

Empirical evidence has grown but the results are very conflicting. Studies by Weisbach (1988), and Mehran (1995) produced evidence in support of a positive role of outside directors on firm performance. Other works have reported no evidence of a significant relationship between firm performance and the proportion of outside directors of the board (Hermalin & Weisbach, 1991; Yermack, 1996).

Unlike the preceding argument in support of board structures, (Laing and Weir, 1999) play down their importance, stressing instead the importance of business experience and entrepreneurship. According to them firms managed by dynamic CEOs tend to perform better than other categories of firms.

2.1.2.2 Board size

The other mechanism proposed to deal with the agency problem is board size. There are arguments in favour of small board size. First, Yermack (1996) argues that large boardrooms tend to be slow in making decisions, and hence can be obstacle to change. A second reason for the support for small board size is that directors rarely criticize the policies of top managers and that this problem tends to increase with the number of directors (Yermack, 1996; Lipton and Loesch, 1992). Yemack (1996) examined the relation between board size and firm performance and concluded that the smaller the boards size the better the performance, and proposed an optimal board size of ten or fewer.

2.1.2.3 Ownership concentration or block holdings

It may be effective to control the manager incentives by being large. The concentration of ownership can avoid the free rider problem. There are several findings supporting that large shareholders play an active role in corporate governance. In Germany, Frank and Mayer (1999) found that large shareholders are associated with higher turnover of directors. Gorton and Schmid (1996) document that block holdings by banks improve companies' performance. In U.S., Morck, *et. al* (1988) find that there is nonlinear relationship (inverted "U") between ownership and company's performance, as measured by their Tobin's Q.

2.1.2.4 The use of leverage

The creditors can exercise some control over firms' decisions. Jensen and Smith (2000) notes that using leverage reduces the agency cost of free cash flow by reducing the cash flow available for spending at the discretion of managers. By using debt, managers bond their promise to distribute future cash flows. Large creditors, like large stakeholders also have interest in seeing that managers take performance-improving measures. Empirical evidence seems to be in support of this assertion. There is a higher incidence of management turnover in Japan in response to poor performance in companies that have a principal banking relation relative to companies that do not (Shleifer and Vishny (1997)).

2.1.2.5 Insider shareholding and firm value

The first argument to address the problem of agency concerns the use of insider shareholding. Several researchers (McConnell and Servaes, 1990 Nor *et al*, 1999; Yeboah-Duah, 1993) have undertaken research on this aspect, reporting very conflicting results. In particular, McConnell and Servaes (1990) find significant curvilinear relationship between insider ownership and firm performance. While Loderer and Martin (1997) find no significant relationship, Nor *et al* (1999) reported a non-linear relationship, drawing conclusions contrary to those of Yeboah-Duah (1993).

2.2 THE RELATIONSHIP BETWEEN OWNERSHIP AND PERFORMANCE

Ownership structure covers both mix and concentration and includes state, institutions, management, individuals and foreigners. Firms have different ownership mixes and the resultant distribution of ownership can impact on managerial opportunism which has implications for managerial behaviour and corporate performance. Ownership and performance too rides on the agency-principle theory as many large companies are not run by people who own them. According to Jensen and Meckling (1976), the costs of deviation from value-maximization decline as management ownership rises. As their stakes rise, managers pay a larger share of these costs and are less likely to squander corporate wealth. According to this convergence-of-interest hypothesis, firm's value increases with board ownership (Morck, Shleifer and Vishny, 1988).

Besides the convergence-of-interest hypothesis, there is another hypothesis about the relationship between ownership structure and performance. The other one is entrenchment hypothesis. Demsetz (1983) and Jensen (1983) have pointed out offsetting costs of significant management ownership. The entrenchment hypothesis predicts that corporate assets can be less valuable when managed by an individual free from checks on his control. Whereas the convergence-of interest hypothesis predicts that larger stakes should be associated with higher market valuation of the corporation, the predictions of entrenchment hypothesis are much less clear-cut. While the convergence-of-interests hypothesis suggests a uniformly positive relationship, the entrenchment hypothesis suggests that market valuation can be adverse for some range of high ownership structure.

The relationship between performance and ownership has been split into two streams and explained as followed.

2.2.2 Concentration of ownership and performance

Concentration of ownership is defined by the number of large-block owners and the percentage of the company's shares that they own. Large-block shareholders are investors who typically

own at least five percent (5%) of the company's shares. Demetz and Lehn (1985) argue that ownership concentration is determined by firm size, control potential, regulation and amenity potential. The opposite of concentrated ownership is diffuse ownership which is characterised by a large number of shareholders with small holdings and few if any large-block shareholders and this subsequently produces weak monitoring of managerial decisions. The benefits of concentrated ownership are that it brings more effective monitoring of management and helps to overcome agency problems thereby leading to improved performance. This positive effect is explained by efficient monitoring hypothesis which contends that higher concentrations of ownership give large shareholders stronger incentives and greater power at lower costs to monitor management.

The costs associated with concentrated ownership are low liquidity and reduced possibilities for risk diversification. Dispersed ownership brings higher liquidity, which can be vital for the development of innovative activity. On the other hand, it does not encourage commitment and long-term relationships that might be required for certain types of investments. For example, when corporations are owned and controlled by each other, this can reduce transaction costs and incentives to engage in opportunistic behaviour. Stakeholders, therefore, have a greater incentive to invest in relationship specific investment. On the other hand, this can also reduce the level of product market competition (OECD, 1999).

Concentrated ownership structure may permit dominant shareholders expropriate minority investors, known as the expropriation-of-minority-shareholders hypothesis. Large shareholders represent their own interests, which need not coincide with the interests of other stakeholders in the firm. Pyramidal control structure, cross shareholding, and super-voting rights allow the controlling shareholders to secure control rights without commensurate cash flow rights (La Porta *et al.*, 1999; Claessens *et al.*, 2000). The divergence between control rights and cash flow rights induces the pervasive problems of controllers' expropriation (Denis and McConnell, 2003). Johnson *et al.* (2000) use the term 'tunnelling' to describe the transfer of resources out of firms for the benefits of controlling shareholders. Small investors' fear of being expropriated may induce the high cost of capital to firms, so it follows inefficient investment.

From the discussion above, several effects can be hypothesized. Greater stock ownership by managers and directors should, by itself, encourage increased effort from these individuals, as well as better company performance and less reluctance to take risk. In the case of directors, stock ownership should provide an incentive to monitor hired managers and bring their performance closer to stockholder expectations. The more a manager's, director's, or large shareholder's wealth is concentrated in an insurance company, the greater one's commitment to the insurance company and the more careful one will be about taking risks and trying to exploit moral hazard incentives from the various policy holders protection mechanisms such as the Policy Holders Protection Fund (PHCF) in the Kenyan scenario. Thus, while greater stock ownership might be expected to make managers and directors less averse to taking risk, having more of one's wealth tied up in an insurance company's stock could lead to the opposite result of a negative relationship with risk taking.

2.2.3 Managerial Ownership (insider ownership) and performance

Some shareholders may be entirely passive investors, whereas others are more active and do perform an important monitoring service. Various motivations and abilities of different types of shareholders may result in their distinctive effectiveness to influence major corporate decisions and value. Jensen and Meckling (1976) formalize the relation between managerial ownership and corporate value. They propose the convergence-of-interest hypothesis to explain the positive effect of managerial ownership. That is, a sufficiently high level of managerial ownership helps align the interests of managers and shareholders resulting in superior performance. A manager's claim on the performance outcomes and burden on the costs associated with non-value maximizing behaviour increase with his fraction of the equity. Thus, a high level of managerial ownership increases the probability that the manager devotes significant effort to creative activities and immunizes himself from misappropriating the corporate resources. The manager will act to maximize firm/shareholder value due to his own interests (Hu and Izumida, 2008).

However, Demsetz (1983) and Fama and Jensen (1983) propound offsetting costs of significant management ownership—the managerial entrenchment hypothesis. According to this hypothesis,

the firm will be less valuable when managers with a significant equity have enough voting power to ensure their position inside the firm. A manager who held smaller shares can be disciplined toward firm value maximization by the market forces, while a manager who controlled a substantial equity can entrench himself from the market restriction, such as the takeover threat or the managerial labour market. Consistent with this, Stulz (1988) developed a model of firm valuation to explain how large shareholdings help managers to be entrenched and decrease the monitoring of external control mechanisms. The impact of managerial ownership on performance therefore is a double-edged sword.

Endogeneity of ownership is another hypothesis that has been used to explain the relationship between ownership and performance. The initial argument about the endogeneity of ownership structure is formulated by Demsetz (1983). He contends that ownership structure should be thought of as an endogenous outcome of decisions that ought to be influenced by the profit-maximizing interests of shareholders. Since Jensen and Meckling (1976), ownership has been supposed to be a determinant of corporate performance, i.e. the causality runs from ownership to performance. Recent studies argue the causation between ownership and performance could, in some circumstances, run in the opposite direction. Holderness (2003) raises a reverse-causation problem: corporate performance may be a determinant of the ownership structure, but not vice versa. It is conceivable that outside shareholders often choose to reward the insiders for good past performance, such as the performance-based compensation in the form of stock options. Moreover, the insider information may create the incentive for managers to change their holdings according to their expectation of future firm performance (Demsetz and Villalonga, 2001). High performance will therefore lead to higher levels of insider ownership. In contrast, when share prices are high relative to expectations, there are large immediate gains and low expected future gains. Insiders may be more tempted to sell parts of their shares in a particular firm at high share prices due to the high risk and opportunity cost of holdings (Pedersen and Thomsen, 2000).

Glassman and Rhoades (1980) compared financial institutions controlled by their owners with those controlled by managers and found that the owner-controlled institutions had higher

earnings. Allen and Cebenoyan (1991) found that holding companies were more likely to make acquisitions that added to firm value when they had high inside stock ownership and more concentrated ownership. Cole and Mehran (1996) discovered higher stock returns at thrifts that had either had a large inside shareholder or a large outside shareholder. These studies thus offer some support for the hypothesis that stock holdings provide an incentive to run an insurance company better and achieve higher earnings for its stockholders.

A number of studies have also examined possible relationships between ownership and risk taking. Saunders, Strock and Travlos (1990) looked at a group of large, publicly traded organizations and found a higher level of risk in organizations where the managers and directors had higher ownership stakes, much as might be expected under principal-agent theory. Other studies have also looked at risk measures derived from stock prices (Anderson and Fraser 2000) or from balance sheet indicators (Cebenoyan, Cooperman and Register 1996), but have not come to consistent conclusions on the effect of inside ownership on risk taking. Several of these studies also explored the influence of outside shareholders on company risk. For instance, Cebenoyan, Cooperman, and Register (1999) found reduced risk levels at thrifts with large outside investors, and Knopf and Teall (1996) found the same type of relationship in thrifts with institutional investors, thus indicating that such shareholders may be protecting their investments by monitoring company management.

An insurance company's performance can be expected to reflect the motivation and goals of officers and stockholders. The incentives driving managers may vary, depending on whether major stockholders form much of the management team or the managers are hired from outside. As financial theory suggests, officers that are also major stockholders will directly benefit through improved stock returns for any steps they take to control costs and improve the company performance. Hired managers with little ownership interest, on the other hand, would not be rewarded in the same manner as owner managers or other stockholders when an insurance company does well.

To deal with the agency problems associated with hired managers, stockholders and directors may have to be more careful in conveying their objectives to these managers, monitoring their performance and finding more effective ways to reward the managers for superior performance. In terms of rewarding managers, many insurance companies have attempted to use performance bonuses, and other means. While these and other steps may help elicit better performance, they are hard to design and may fail to provide the same incentives as significant stock ownership.

Spong and Sullivan, (2007) carried out a study that focused on the daily managing officer of a company and his or her stockholdings. This officer is the one who is responsible for the company's daily operations and must make and oversee many of the decisions that come up within the normal course of business. The daily managing officer is thus in a position to have the most impact on insurance company profitability, and his or her ability to serve the interests of stockholders will be a major factor in an insurance company's performance. Spong and Sullivan (2007) estimated that the relationship between insurance company profit efficiency and the manager's family ownership of the insurance company is distinctly different for hired managers compared to owner managers. For instance, they noted a marked change in profit efficiency for small changes in ownership of hired managers. In owner-manager insurance Companies, by contrast, profit efficiency changes little in response to changes in manager ownership. This reflects the fact that owner managers already have substantial control over their organizations so that added ownership provides little incentive to alter behaviour.

Studies in this field have shown that the incentive of ownership can help to mitigate principal-agent conflicts and corporate governance issues by spurring hired managers to improve the performance of their companies. However, studies on insurance companies worldwide reveal that only one-third of hired managers have more than a trivial ownership stake in their companies. This outcome suggests that ownership is a greatly underutilized tool in combating agency costs and governance problems.

There are factors that suggest that the overall performance of many owner- managed insurance companies may meet or exceed that of hired-manager insurance companies. First, owner managers in insurance companies have incentives to shift part of the remuneration they would otherwise receive in the form of company earnings and dividends into additional salary and other benefits for themselves, thus reducing the double taxation they would face on earnings. This tax avoidance strategy would thus serve to understate the actual earnings and reduce the insurance company's estimated profit efficiency. Second, many owner managers may perform well, but, due to their personal financial situation, are willing to trade off better returns for a lower risk exposure and more secure financial position.

2.3 PERFORMANCE

Performance refers to the extent to which an organisation's goals and objectives are achieved effectively and efficiently. Performance can take many forms depending on who and what the measurement is intended for. Different stakeholders require different performance indicators to enable them make informed decisions. The content, format and frequency of reports depend on who needs the information and for what purpose (Kihara, 2006). Shareholders will want to be certain about the viability, growth, profitability, return on investment and continued financial sustainability of the firm (Brown *et al*, 2003). It is recognised that the information availed to the shareholders is normally a condensed summary of varied operational and management reporting that reflect many and important going-on in the corporation. Provided full disclosure of the information is made, the reporting to shareholders will contain sufficient information to give accurate report of the financial health of the firm.

2.3.1 Measures of Financial Performance

Financial performance measures analyse the financial statements of an organisation. There are three statutory financial statements, which are; the statement of financial position, the statement of comprehensive income and the cash flow statement. These financial measures seek to evaluate management performance in areas such as profitability, efficiency and risk. In financial analysis ratios are used and they can be grouped into liquidity, operating, market value ratios, and profitability ratios (Reilly and Brown, 1997).

2.3.1.1 Market to Book value Ratio (MBV)

Institutional investors in the U.S.A use the market to book value ratios to assess performance when selecting target firms. Xu and Wang (1997) used the MBV ratio as a measure of the market performance of 100 Chinese town and village enterprises listed in two Chinese stock exchanges.

MBV Ratio is calculated as the share prices on the last day of trading of each year times the number of total outstanding share divided by the book value of equity. (Xu and Wang, 1997)

$$\text{MBV} = \frac{\text{Mp} \times \text{No. Of shares}}{\text{Book value of Equity}}$$

Book value of Equity

Whereby: Mp represents Market Price of Shares.

2.3.1.2 Return on Equity (ROE)

Return on equity or ownership capital is the most significant profitability measure to investors. To the investor, the measure reports returns on dollar invested to permit comparisons across firms. To management, the ratio is important because it can be dissected to reveal sources of financial performance. If this ratio is higher than the industry average, this may indicate poor management of working capital. If the ratio is too low, this may not be bad if the current assets are very liquid (cash or securities) (Xu and Wang, 1997).

$$\text{ROE} = \frac{\text{After tax Profit}}{\text{Book value of equity}}$$

2.3.1.3 Return on Assets (ROA)

Return on assets measures a company's earnings in relation to all the resources it had at its disposal (the shareholders' capital plus short and long-term borrowed funds). Thus, it is most stringent and excessive test of return to shareholders. If a company has no debt, its return on assets and return on equity figures will be the same.

The ROA Measure of profitability is not affected by the company's capital structure. The ratio

measures the amount of plant and equipment, and other assets employed to generate profits (Xu and Wang, 1997).

$$\text{ROA} = \frac{\text{Profit after tax + interest (before tax)}}{\text{Total Assets}}$$

2.3.1.4 Tobin's Q

Tobin's Q has been used as a major indicator of a firm's performance (Xu and Wang, 1997). The correlation between the simple Q and a measure of Q that attempt to use market value throughout is as high as 0.97. Tobin's Q measures expected future profitability due to valuable growth opportunities and/or competitive advantage. It is calculated as follows:

$$\text{Tobin's Q} = \frac{\text{Market value of Debt} + \text{Market value of Equity}}{\text{Replacement costs of all assets}}$$

2.4 EMPIRICAL EVIDENCE

Earle *et al.* (2005) carried out a study on the relationship between ownership and corporate performance across 168 firms in Hungary for the period 1996 to 2001. They used the return on equity (ROE) and real sales to number of employees measures and concluded that the size of the largest block increases profitability and increases profitability and efficiency strongly and monotonically.

Claessens and Djankov (1999) found a 10% increase in ownership concentration led to a 2% increase in short-term labour productivity and a 3% increase in short-term profitability in the Czech Republic. Earle *et al.* (2005) study implied that the size of the largest block increases profitability and efficiency strongly and monotonically in Hungary over 1996 to 2001. Xu and Wang (1999) studied a sample of all listed companies in China for the period 1993-1995 using a single linear equation as a measure and concluded that profitability is positively correlated with concentration and legal person holding, but uncorrelated with state shares and tradable A-shares

(A-shares, on the Shanghai and Shenzhen stock exchanges refers to those that are traded in Renmimbi, the currency in mainland China.).

Morck *et al.* (1988) examined the relationship between management ownership, as measured by the combined stake of all board members, and market value of the firm, as measured by Tobin's Q, for a 1980 cross-section of 371 Fortune 500 firms. To test two hypotheses of the convergence-of-interest and entrenchment, they estimated piecewise linear regressions allowing for slopes to change at two turning points, 5 and 25 percent. The results showed that in some ranges of ownership (below 5 percent and over 25 percent), Tobin's Q was positively related to board ownership, but in others, a negative relation is found. Following Morck *et al.* (1988), McConnell and Servaes (1990) and Holderness *et al.* (1999), among others, found a significantly inverse U-shaped relationship in the similar way. The results suggested that the convergence-of-interest effect is more important at both low levels and high levels of managerial ownership, but the entrenchment effect is dominant at the medium levels of shareholdings.

Holderness *et al.* (1995) studied 3,759 firms in the United States of America and using the market to book value measure concluded that the performance-ownership relationship is weak. They compared this with a study of 1,236 firms in 1935 and the relation was weaker for the 1995 sample.

Claessens and Djankov (1999) studied a sample of 706 firms in the Czech republic using profitability and labour productivity as a measure and concluded that a 10% increase in concentration leads to a 2% increase in short-term labour productivity and a 3% increase in short-term profitability.

The most prominent example of the first type of study on the relationship between corporate governance and performance across countries is La Porta *et al.* (1999), who investigated differences in governance standards among 27 countries. Their evidence shows that firms incorporated in countries with better governance standards tend to have a higher valuation.

Studies investigating inter-firm variation within one country are Drobetz *et al.* (2004) for Germany, Gompers *et al.* (2003) for the US and Black (2001) for Russia. These studies generally find a positive relationship between governance standards and firm value. Comparing the findings of these studies, it is worth noting that the relationship seems to be stronger in countries with less developed standards.

Black (2001) finds that good governance practices are strongly correlated with higher firm value as measured by the ratio of actual market capitalization to theoretical western market capitalization. Using corporate governance rankings for 495 firms in 25 emerging markets compiled by the Credit Lyonnais Securities Asia in 2001, Klapper and Love (2002) show that better corporate governance is highly correlated with better operating performance and market valuation. Klapper and Love (2002) also find that corporate governance provisions at the firm level matter more in countries with weak legal environments. As Doidge, Karolyi, and Stulz (2001) suggest, controlling shareholders in countries with poor investor protection are giving up (and returning to outside shareholders) potentially large private gains by putting good corporate governance practices in place. Thus investors in these countries appreciate good corporate governance practices more than investors in countries with strong legal environments.

Unlike for board composition, a fairly clear negative relationship appears to exist between board size and firm value (Eisenberg, *et al.*, 2006) Too big a board is likely to be less effective in substantive discussion of major issues and to suffer from free-rider problems among directors in their supervision of management (Hermalin and Weisbach 1991).

Bertrand and Mullainathan (1999) find that the presence of state takeover laws decreases firm-level efficiency in terms of total factor productivity or return on capital. They show that this result is at least partly due to increased agency costs evidenced by increased compensation for CEOs and employees. Sundaramurthy, Mahoney, and Mahoney (1997) show that negative market reactions to anti-takeover provisions vary depending on firms' board structure. Separation of the positions of CEO and chairperson of the board reduces the negative effects, while increased outsider representation increases negative market reactions.

Kaur and Gill (2008) carried out a study of the impact of corporate governance on performance in Indian firms and sampled 134 companies of Bombay Stock Exchange (BSE) 200 Index for six financial years from FY 2000-2001 to FY 2005-2006. The research found significant positive effect of institutional ownership on company profitability. There was also evidence for the fact that higher promoters' ownership (both Indian and foreign) leads to higher corporate performance. The results are further confirmatory to findings regarding insignificant effect of non-institutional investors on performance.

Gompers *et. al.* (2003) used Investor Responsibility Research Centre (IRRC) data constructed a "Governance Index" to proxy for the level of shareholder rights of about 1500 large firms during the 1990s. An investment strategy that bought firms with the strongest rights and sold firms with the weakest rights would have earned abnormal returns of 8.5 percent per year during the sample period. They find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. Gompers *et. al.* (2003) classify 24 governance factors into five groups: tactics for delaying hostile takeover, voting rights, director/ officer protection, other takeover defences, and state laws. They provide additional evidence on the association between audit-related governance factors and firm performance by showing that: (1) solely independent audit committees are positively related to dividend yield, but not to operating performance or firm valuation; (2) auditors ratified at the most recent annual meeting are unrelated to all of our performance measures; (3) consulting fees paid to auditors less than audit fees paid to auditors are negatively related to four of our six performance measures; and (4) company has a formal policy on auditor rotation is positively related to return on equity but not to any of our other five performance measures. They concluded that firms with fewer shareholder rights have lower firm valuations and lower stock returns.

Using a sample of 452 firms in the annual *Forbes* magazine rankings of the 500 largest U.S. public firms between 1984 and 1991, Yermack (1996) shows that firms are more valuable when the CEO and board chair positions are separate.

These contradictory results could be explained in part by the non-linearity of the relationship between ownership structure and firm performance. Morck, Shleifer and Vishny (1988) conducted a study in the United States over the year 1980 and analyzed the relationship between the percentage of shares held by managers and corporate financial performance. They found a positive relationship for holdings within the range 0% and 5%, a negative relationship for holdings between 5% and 25%, and a positive relationship again for holdings beyond 25%. These results suggest that the effect of alignment is dominant for holdings between 0% and 5% or above 25%, but in the range of 5% to 25%; it is the entrenchment effect that prevades.

Thuku (2002) found no significant relationship between ownership structure and performance of banks in Kenya. The only form of ownership that seems to affect the performance of firms listed on the NSE is foreign ownership, the other forms of ownership like individual, institutional, government and local ownership, do not have any significant correlation with the performance of firms listed at the NSE (Oltetia, 2002). Onyango (2004) argues that ownership structure firm's value is maximized at higher levels of ownership concentration. Kihara (2006) studied all the firm listed in the Main investments segment at the Nairobi Stock exchange between a period of 2000-2004 and found no relationship between ownership, governance and performance eof those firms.

2.5 CONCLUSION

Companies operate under a wide variety of management and ownership structures. Some have hired managers and others are managed by individuals with a controlling interest in the company. Ownership structures can also vary from having just a few owners to having a widely dispersed group of shareholders or being an actively traded company. Other differences range from company Boards with few outside directors to many outsiders and from key stockholders with diversified portfolios to those that have all their financial resources tied up in that company. Companies, both small and large - must base their operating structure on the type of investors they are able to attract, the quality of management that is available, and the individuals that are willing to serve as directors as they target to optimise returns.

Managers and their ownership incentives, directors and their monitoring role, all the key policymakers/owners and the amount of wealth they have concentrated in the company, and

regulatory discipline ó have a key influence on the governance framework in companies. Each of these elements may serve to reinforce other elements, be a substitute for other pieces of the governance framework, or interact in other ways in the governance process.

Within each company's governance framework, a variety of inherent weaknesses, potential problems, and conflicts of interest can exist among the key participants. Financial theory, though, demonstrates a number of steps that stockholders and directors can take to address shortcomings in their ownership and management structure and bring company performance closer to stockholder and regulatory preferences. These corrective steps largely reflect the critical role that ownership and wealth play in business ventures. Similarly, boards of directors are likely to have a more positive effect on company's performance when directors have a significant financial interest in the company. This financial stake provides a means for directors to benefit directly from their own actions and thereby encourages directors to play a more active role in monitoring management.

Further, managerial ownership, along with wealth and the financial positions of managers and directors, significantly influences an company's risk decisions and risk-return trade-offs. While no single risk position is appropriate for all company's and all investors, it is important for shareholders to ensure that their own preferences are reflected in their company's operations.

Hired managers with no stock ownership may be reluctant to take on as much risk as other managers, since non-stockholding managers will not directly receive the returns from successful ventures and may be putting their jobs at risk in the event of adverse outcomes. An ownership stake for these managers, though, can help to overcome this risk aversion. Wealth concentration or the portion of assets managers have tied up in their own insurance company can play a separate and equally significant role in an insurance company's risk taking. Insurance companies in which managers or principal owners and directors have invested much of their own wealth in the business operate with lower risk exposures.

Research indicates that each of these ownership and wealth relationships can have a significant effect on a company's overall performance, and that companies with management and ownership weaknesses have the potential to improve their operations substantially by addressing these shortcomings. Although some of these ownership, management and governance adjustments may take time, it is important for companies and company regulators to identify corporate governance problems and decide what corrective steps are needed.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 RESEARCH DESIGN

The research design adopted for this study was a survey design. This study investigated the relationship between ownership structure, governance structure and financial performance of insurance firms in Kenya

3.2 THE POPULATION AND SAMPLE

The population comprised insurance companies licensed in the insurance sector in Kenya as at the end of 2009. During this period, there were 41 licensed insurance companies whereby twenty companies wrote general insurance business only; seven wrote long term business only while fifteen were composite insurers (IRA Annual report, 2009).

The study was done covering a period of five years-from 2005 to 2009. The period allowed for greater comparability of the results.

3.3 DATA COLLECTION

Data used in this study was secondary data, constituting the company's financial statements covering the five years from 2005 to 2009. The use of the financial statements was considered more appropriate as they gave an overall company position. The annual reports of listed companies were available at the Insurance Regulatory Authority, and in the respective insurance companies' offices. Data on ownership and governance structures was also obtained from the Insurance Regulatory Authority.

3.4 DATA ANALYSIS

Data was analyzed using Microsoft Excel 2007 statistical package since it was best suited for providing a means of establishing quantitative association between variables. To determine the performance of the firms the financial ratios used included; Return on Asset ratio (ROA), and Return on Equity ratio (ROE).

$$\text{ROE} = \frac{\text{After tax profit}}{\text{Book value of equity}}$$

$$\text{ROA} = \frac{\text{Profit after tax + interest (before tax)}}{\text{Total assets}}$$

Equation to establish the relationship between ownership structure, governance structure and performance of firms, relied on multiple regression.

The general regression equation was of the form:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + e$$

Where Y was financial performance measured in terms of ROA and ROE.

β_1 was the measure of size of the board (Number of Directors)

β_2 was the measure of number of non executive directors on the Board

β_3 was the measure of ratio of debt to share capital

β_4 was the measure of ownership concentration

β_5 was the measure of director shareholding

α is the constant term representing performance which is explained by other factors other than ownership structure and governance structure.

X_1, X_2, X_3, X_4 and X_5 are coefficients of ownership structure and governance structure

e is the error term

Measures of a good governance structure included ownership concentration, amount of leverage used, size of the Board, composition of board members and director shareholding (Weisbach, 1988; Hermalin and Weisbach,1991; Yermack,1996). These variables were measured as follows:

Table 1: List of variables

Variable	Definition	Measurement
Board Size	Board Size	Number of directors on the board.
Dirshare	Director Shareholding	Total Number of shares owned by Director of a given firm as a percentage of the outstanding shares (the higher the percentage the greater the director shareholding).
Outside	Number of directors on the board.	Proportion of outside directors sitting on the board.
Ownership	Ownership Concentration	The proportion of shares owned by the largest shareholders divided by the number of the largest shareholders
Debt	Leverage	The ratio of debt to share capital

Source: Author

Once the regression was obtained, a significance test was conducted to identify which variables were more important. The students' "t" statistics and P - values were used. N-2 degrees of freedom at 95% level of confidence were used to obtain the critical t-values. The Durbin Watson test was used to test autocorrelation.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 DATA ANALYSIS

In this chapter, the descriptive statistics of the study variables is discussed. This chapter also discusses the empirical findings of this study and also gives a summary of the findings and interpretation with regard to the study objective. The objective of this study was to find out if there exists a relationship between ownership structures, governance structures and financial performance of insurance companies in Kenya.

4.2 GENERAL OVERVIEW- DESCRIPTIVE STATISTICS

This study consists of all the 41 insurance companies that were licensed by IRA in the period under study. However, information on two companies was not available therefore only 39 companies were analysed. The variables that were used for this study include:

1. Board Size, measured by the number of directors on the board.
2. Outside directors/non-executive directors, measured by the number of outside directors sitting on the board.
3. Debt/Leverage ratio, measured by the ratio of debt to capital.
4. Ownership concentration measured by the proportion of shares owned by the largest shareholders divided by the number of the largest shareholders.
5. Information on director shareholding was not available from the information obtained from IRA and from the companies' annual reports. This variable was therefore excluded from the model during analysis.

Table 2: Descriptive statistics of the overall industry

	SIZE		NON-EXECUTIVES		LEVERAGE	
	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
2009	6.8205	2.1989	5.6923	2.1662	0.2477	0.8339
2008	6.8462	2.1465	5.7179	2.1020	0.3610	1.5849
2007	6.6667	2.4098	5.5641	2.2918	0.1345	0.1938
2006	6.4615	2.6242	5.3590	2.4223	0.1060	0.1746
2005	6.4615	2.6242	5.3590	2.4223	0.1012	0.1681

* Source: Research Data

Over the five year period the average number of board members for Kenyan insurance companies was either 6 or 7 with non-executive board members being either 5 or 6. There has been no major deviation in both the board size and number of non-executive members on the various boards during the period studied. Leverage ranged between 10.1% and 36.1% with a major deviation being witnessed in 2008 perhaps due to the 2007 post election violence aftershocks that rocked the insurance industry. However, in 2009 industry financial leverage appears to have eased with improved economic prospects.

4.3 DESCRIPTIVE STATISTICS (CROSS-SECTIONAL ANALYSIS)

Table 3: Descriptive statistics comparing a cross-section of the companies (Listed vs. Non Listed)

Listed	Size	Non-executive		Leverage	ROA	ROE
Jubilee Insurance	8	8		5.29%	3.01%	23.71%
Pan Africa Life	9	7		1.99%	3.85%	13.89%
Mean	8.5	7.5		3.64%	3.43%	18.80%
Non-listed						
APA Insurance Company	7	6		0.00%	5.43%	17.99%
Co-operative Insurance Co	12	11		0.60%	1.44%	6.09%
Insurance Company of East Africa	8	7		29.56%	1.13%	14.58%
Metropolitan Life Insurance	6	5		16.19%	-25.94%	-68.21%
Real Insurance Company	7	7		26.82%	5.47%	33.19%
Mean	8	7.2		14.63%	-2.49%	0.73%

* Source: Research Data

The mean trends appear to indicate that there has not been any major difference in corporate governance between the listed and non-listed insurance companies which disclosed block shareholding information; given that board sizes and the number of non-executive directors on the board are quite similar. This is despite the fact that listed insurance companies operate under additional CMA corporate governance guidelines that the rest of the insurance companies are not subjected to. With the exception of the Corporative Insurance Company (CIC), the rest of the six companies had a block shareholding of above 50%. Leverage was lower for non-listed firms perhaps due to the ability of these firms to raise equity capital through the issue of new shares at the Nairobi Stock Exchange (NSE).

With regard to returns, listed companies posted better aggregate result over the five-year period to 2009 with an average return on assets (ROA) of 3.43% and a return on equity (ROE) of 18.8% compared to -2.49% and 0.73% respectively for the non-listed firms above. But given that there was no major difference in board size and constitution, the difference in returns may not be attributable to the corporate governance framework or ownership.

Table 4: Descriptive statistics comparing a cross-section of the companies (Regional Vs. Local Companies)

	Size	non-executive		Leverage	ROA	ROE
REGIONAL						
Mean	7	6		8.64%	3.91%	16.10%
Stdev	2	2		9.33%	2.36%	14.68%
LOCAL						
Mean	7	6		21.61%	2.99%	13.19%
Stdev	2	2		59.10%	6.99%	25.48%

* Source: Research Data

Similarly, no major differences can be deduced in board size and constitution when regional insurance firms are compared to strictly local insurance entities. Accordingly, the generally higher returns for regional insurance firms may be more as a consequence of regional market capture as opposed to internal corporate governance initiatives.

Leverage for regional firms was much lower given that the firms have a larger market base and subsequently this has tended to boost their working capital and stave off the need for working capital reinforcement through leverage.

Table 5: Descriptive Statistics comparing General and composite vs. Life Insurers

	SIZE		NON-EXECUTIVES		LEVERAGE	
	General	Life	General	Life	General	Life
2009	6.8125	6.8571	5.6563	5.8571	0.1132	0.8627
2008	6.9063	6.5714	5.7500	5.5714	0.0996	1.5556
2007	6.9063	5.5714	5.7500	4.7143	0.1268	0.1697
2006	6.6563	5.5714	5.5000	4.7143	0.0897	0.1804
2005	6.6563	5.5714	5.5000	4.7143	0.0845	0.1845

* *Source: Research Data*

Mean statistics indicate that board size for life insurance firms has generally been smaller over the five year period but by 2009 these boards were similar in size to those of general and composite insurance companies. By virtue of the smaller board sizes the number of non-executives sitting on life insurance boards was also smaller from 2005 to 2007. On the other hand, life insurance companies, on average, had a higher leverage for the five-year period. General insurance firms are able to generate greater premiums as general business tends to elicit more business because insurance products such as fire and motor vehicles are made mandatory by law; hence more premiums can be obtained via general business and subsequently the profits derived therein boost shareholder equity and lower leverage levels below those of life business.

Table 6: Standard Deviation (General vs. Life)

	SIZE		NON-EXECUTIVES		LEVERAGE	
	General	Life	General	Life	General	Life
2009	1.8741	3.5322	1.9937	3.0237	0.1607	1.9320
2008	1.8379	3.4087	1.9510	2.8785	0.1604	3.7076
2007	1.8379	4.1975	1.9510	3.5456	0.1762	0.2753
2006	2.1940	4.1975	2.1553	3.5456	0.1364	0.2984
2005	2.1940	4.1975	2.1553	3.5456	0.1389	0.2754

* *Source: Research Data*

Deviation in both the board size and number of non-executives was higher for life insurance firms compared to general insurance firms. This probably has to do with the continual increase in board size of the life insurance companies which were initially smaller in size. Likewise, life insurance firms recorded greater deviation in leverage implying greater financial volatility.

4.4 REGRESSION ANALYSIS

Table 7: Regression Analysis 1

	ROA	ROE
Intercept	-0.0234	-0.0983
	(-0.5484)*	(-0.6421)*
(Size)	0.0067	-0.0182
	(0.3452)*	(-0.2619)*
(Non-exec)	0.0011	0.0619
	(0.0571)*	(0.8851)*
(Leverage)	0.0237	0.0762
	(1.0122)*	(0.9090)*
R ²	0.0613	0.1338
DW	1.8899	1.8513

*Significant at the 5% level

Source: Research Data

t-Statistic in parenthesis

Size, outside (non-executive) directorships and leverage had a significant impact on both return on assets (ROA) and return on equity (ROE). For ROA, the relationship with size, outside directorship and leverage was positive indicating that an increase in all the three variables led to a significant increase in the return on assets. The same case applied to ROE with the exception of size whereby increase in board size was found to have a significant but negative relationship to the return on equity.

The R^2 indicates that the three independent variables, size outside directorship and leverage account for 6.13%, and 13.38% of the explained variance in ROA and ROE respectively. The Durbin Watson (DW) statistic indicates that serial correlation is minimal since DW is near or around 2.0 for all the regression analysis equations.

Table 8: Regression Analysis II

	ROA	ROE
Intercept	-0.5039	-1.2531
	(-1.5584)*	(-1.1884)
Size	-0.0877	-0.2908
	(-1.2611)*	(-1.2822)*
non-exec	0.1142	0.3605
	(1.4902)*	(1.4424)*
Leverage	-1.1553	-2.8606
	(-1.8781)	(-1.4259)
Ownership	0.7572	2.0380
	(1.7703)	(1.4610)
R^2	0.5631	0.4797
DW	2.0694	2.0586

*Significant at the 5% level

t-statistic in parenthesis

Source: Research data

From the data collected it was observed that only about 30% of the firms studied disclosed ownership data. As a result a second regression analysis was undertaken constituting only those insurance firms that disclosed block shareholding data. In this case, size had a significant but negative effect on the relationship with both return on assets (ROA) and return on equity (ROE) while outside (non-executive) directorships had a significant but positive on relationship with

both return on assets (ROA) and return on equity (ROE). On the other hand, ownership did not register any significant impact on any of the dependent variables namely ROA, and ROE.

The R^2 indicates that the two independent variables, size outside directorship and leverage account for 56.31%, and 47.97% of the explained variance in ROA and ROE respectively. The Durbin Watson (DW) statistic indicates that serial correlation is minimal for the ROA and ROE regressions since DW is near or around 2.0 for the two regression analysis equations.

4.5 SUMMARY OF FINDINGS AND INTERPRETATION

Over the five year period, the average number of board members for Kenyan Insurance companies was in the range of 6 or 7 with non-executive board members being either 5 or 6. A major deviation in leverage was witnessed in 2008. Further, the study did not find any board constitution for listed companies different from non-listed companies despite listed companies being subject to the CMA corporate governance guidelines.

Smaller board sizes were witnessed in life insurance boards between 2005 and 2007 with life insurance companies having a higher leverage for the five-year period to 2009. However, general insurance firms were able to generate greater premiums as general business tends to have more business because of mandatory insurance products such as fire and motor vehicles and as a result they recorded a lower leverage over the five-year period.

The study also found that there was a significant relationship between size, outside (non-executive) directorships and leverage with both return on assets (ROA) and return on equity (ROE). This study did not find a significant relationship between ownership and financial performance of insurance companies.

The study also found that there was a significant and positive relationship between outside (non-executive) directorships with both return on assets (ROA) and return on equity (ROE). When ownership was not taken into account, there was a significant and positive relationship between

ROA and size but when ownership was taken into account the relationship became negative. Leverage was found to be significant and positive to changes in ROA only when ownership was not taken into consideration. Further, the study did not find a significant relationship between performance of insurance companies and ownership. The effect of ownership would have probably changed if we had been able to obtain the more details of director shareholding.

The findings indicate that board size and constitution, and financial leverage have a significant impact on both return on equity and return on assets and as such bear credence to the role of corporate governance structures in spurring performance in the insurance industry. The positive relationship between ownership and financial performance of insurance firms appears to suggest that block holder ownership enhances rather than hinders performance and as a result institutions with larger block holdings do not require a large board size to accommodate non-executives.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

This chapter concludes the study and the implications of the main findings. It also gives recommendations that maybe adopted by various policy makers and institutions for the well being of all stakeholders in the insurance industry. It also discusses limitations that maybe in this study and suggest areas that need further research.

5.2 CONCLUSIONS

Given the fact that the study finds that there was a significant relationship between size, outside (non-executive) directorships and leverage with both return on assets (ROA) and return on equity (ROE), this is a pointer to the significant role of corporate governance structures in determining the financial performance of insurance companies in Kenya.

The positive relationship between ownership and financial performance of insurance firms coupled with the significant but negative relationship between ROA and board size, when ownership is taken into account, appears to suggest that block holder ownership enhances rather than hinders performance and as a result institutions with larger block holdings do not require a large board size to accommodate additional non-executives given that concentrated block holdings have had a positive relationship with the financial performance of insurance firms.

5.3 POLICY RECOMMENDATIONS

This study not only contributes to the literature around performance of insurance companies but also to literature related to corporate governance. Going forward, insurance companies should carefully monitor their corporate governance structures with a view to improving their financial performance. In addition, they should also address issues of financial leverage so as to optimize returns. The Insurance Regulatory Authority should also come up with a corporate

governance benchmark for the industry in order to boost performance. This is expected to subsequently attract more people to take up policies which will improve the profitability of the industry and the economy in general.

5.4 LIMITATIONS

Some aspects of secondary data such as ownership were not disclosed in the annual financial report filed for most companies with the Insurance Regulatory Authority (IRA) and as a result this data could not be collated and summarized. Hence this study incurred the limitation of being unable to establish the full extent of the effect of ownership concentration and director shareholding of insurance companies.

5.5 RECOMMENDATIONS FOR FURTHER STUDIES

The study mainly focused on the impact of corporate governance and ownership structures on financial performance of insurance companies but was unable to establish the full impact of director shareholding on financial performance. Accordingly, should data be availed in future with regard to director shareholding, then a study may be undertaken to assess its impact on financial performance of insurance firms.

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APPENDICES

APPENDIX 1 LIST OF REGISTERED INSURANCE COMPANIES

1.	African Merchant Assurance Company	22.	Kenindia Assurance Company
2.	APA Insurance Company	23.	Kenyan Alliance Insurance Company
3.	Apollo Life Assurance Company	24.	Kenya Orient Insurance Company
4.	Blue Shield Insurance Company	25.	Lion of Kenya Insurance Company
5.	British American Insurance Company	26.	Madison Insurance Company
6.	Cannon Assurance Company	27.	Mayfair Insurance Company
7.	CFC Life Assurance Company	28.	Mercantile Insurance Company
8.	Chartis Kenya Insurance Company	29.	Metropolitan Life Insurance Kenya Ltd.
9.	Concord Insurance Company	30.	Monarch Insurance Company
10.	Co-operative Insurance Company	31.	Occidental Insurance Company
11.	Corporate Insurance Company	32.	Old Mutual Life Assurance Company
12.	Directline Assurance Company Ltd	33.	Pan Africa Life Assurance Company
13.	Fidelity Shield Insurance Company	34.	Pacis Insurance Company Ltd
14.	First Assurance Company	35.	Phoenix of East Africa Assurance Company
15.	Gateway Insurance Company	36.	Pioneer Life Assurance Company
16.	Geminia Insurance Company	37.	Real Insurance Company
17.	General Accident Insurance Company	38.	Tausi Assurance Company
18.	Heritage Insurance Company	39.	Trident Insurance Company
19.	Insurance Company of East Africa (ICEA)	40.	Trinity Life Assurance Company
20.	Intra Africa Assurance Company	41.	UAP Provincial Insurance Company
21.	Jubilee Insurance Company		

APPENDIX 2: RESULTS TABLE

<i>Name</i>	ROA	Size	<i>non-executive Directors</i>	Leverage		ROE	Size	<i>non-executive Directors</i>	Leverage
African Merchant Assurance Company (AMACO)	0.05	7	5	0.00		0.13	7	5	0.00
APA Insurance Company	0.05	7	6	0.00		0.18	7	6	0.00
Apollo Life Assurance Company	0.08	0	0	3.28		0.24	0	0	3.28
British American Insurance Company	0.03	6	4	0.06		0.23	6	4	0.06
Cannon Assurance Company	0.03	7	6	0.00		0.07	7	6	0.00
CFC Life Assurance Company	0.02	9	8	0.00		0.27	9	8	0.00
Chartis Kenya Insurance Company	0.10	7	6	0.00		0.49	7	6	0.00
Concord Insurance Company	0.02	5	4	0.48		0.09	5	4	0.48
Co-operative Insurance Company	0.01	12	11	0.01		0.06	12	11	0.01
Corporate Insurance Company	0.03	7	6	0.01		0.10	7	6	0.01
Directline Assurance Company Ltd	0.01	5	3	0.00		0.02	5	3	0.00
Fidelity Shield Insurance Company	0.05	6	4	0.00		0.17	6	4	0.00
First Assurance Company	0.06	6	5	0.03		0.24	6	5	0.03
Gateway Insurance Company	0.04	6	5	0.11		0.18	6	5	0.11
Gemina Insurance Company	0.01	6	5	0.00		0.05	6	5	0.00
General Accident Insurance Company	0.06	5	4	0.14		0.18	5	4	0.14
Heritage Insurance Company	0.04	11	9	0.04		0.11	11	9	0.04
Insurance Company of East Africa (ICEA)	0.01	8	7	0.30		0.15	8	7	0.30
Intra Africa Assurance Company	0.02	6	5	0.00		0.09	6	5	0.00
Jubilee Insurance Company	0.03	8	8	0.05		0.24	5	5	0.05
Kenindia Assurance Company	-0.01	8	7	0.16		-0.16	8	7	0.16
Kenyan Alliance Insurance Company	0.09	5	4	0.01		0.24	5	4	0.01
Kenya Orient Insurance Company	0.01	5	4	0.00		0.02	5	4	0.00
Lion of Kenya Insurance Company	0.06	7	6	0.14		0.22	7	6	0.14
Madison Insurance Company	0.01	7	5	0.06		0.04	7	5	0.06
Mayfair Insurance Company	0.00	7	6	0.02		-0.01	7	6	0.02

<i>Name</i>	ROA	Size	<i>non-executive Directors</i>	Leverage		ROE	Size	<i>non-executive Directors</i>	Leverage
Mercantile Insurance Company	0.03	9	7	0.18		0.09	9	7	0.18
Metropolitan Life Insurance Kenya Ltd.	-0.26	6	5	0.16		-0.68	6	5	0.16
Monarch Insurance Company	-0.01	6	5	0.39		0.00	6	5	0.39
Occidental Insurance Company	0.05	8	7	0.22		0.17	8	7	0.22
Pan Africa Life Assurance Company	0.04	9	7	0.02		0.14	3	3	0.02
Pacis Insurance Company Ltd	0.20	13	12	0.14		1.06	13	12	0.14
Phoenix of East Africa Assurance Company	0.03	5	3	0.01		0.13	5	3	0.01
Pioneer Life Assurance Company	0.00	7	6	0.04		0.01	7	6	0.04
Real Insurance Company	0.05	7	7	0.27		0.33	7	7	0.27
Tausi Assurance Company	0.00	5	5	0.44		0.01	5	5	0.44
Trident Insurance Company	0.12	7	6	0.05		0.40	7	6	0.05
Trinity Life Assurance Company	-0.02	6	5	0.59		-0.07	6	5	0.59
UAP Provincial Insurance Company	0.08	8	6	0.00		0.15	8	6	0.00
	β_3	β_2	β_1	β_0		β_3	β_2	β_1	β_0
REGRESSION COEFFICIENTS	0.0298	-0.0039	0.0130	-0.0409		0.0762	0.0619	-0.0182	-0.0983