

**THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE STRUCTURE  
AND THE PERFORMANCE OF BANKS LISTED ON THE NAIROBI STOCK  
EXCHANGE**

**BY**

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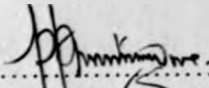
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## DECLARATION

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

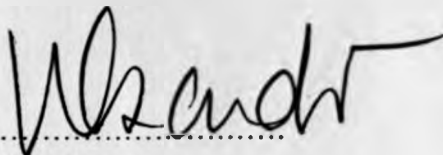
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This project has been submitted for the examination with my approval as University supervisor,

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## **DEDICATION**

This study is dedicated to my loving family, for their support, encouragement and patience during the entire period of my study and continued prayers towards successful completion of this course.

May God bless you all.

## ACKNOWLEDGEMENT

I wish to express my sincere appreciation to my family for their understanding and support during the project. Particularly, I pay glowing gratitude and tribute to my lovely wife Josphine and my daughter Purity, thank you for your love and support; you are such a wonderful gift and blessings to be with.

I would like to acknowledge the guidance and monitoring provided by my Supervisor Mrs Winnie Nyamute in developing this project report.

Lastly I thank Almighty God for his guidance and providence which enabled me to undertake this project that was too involving in term of time and resources.

## ABSTRACT

Corporate governance practices, principles and structures have recently gained popularity in the developing world. Corporate governance is the system through which corporations are directed and controlled. On the other hand, the main goal of company is to maximize the wealth of shareholders. With the recent problems across the world for example the collapse of major corporations like Enron and Lehman brothers, the impact of corporate practices has increased profoundly. Governments are also reducing their control in state owned corporations through the sale of their shareholding to the public (KCB and NBK). With such growth in the amount of control being relinquished to the public in return demand better governance of their corporations.

The research was conducted using a Cross-sectional survey that sought to identify differences in corporate governance's structures between listed banks facing a decline in values and those with appreciating values, and those with stable value on calendar years 2003, 2004, 2005, 2006, 2007 and 2008. The study targeted all banks in Kenya for the period of five years (2002 to 2007). The sample size included all the listed banks (nine in number) in the stated period. Secondary data sources were used where by internal secondary research i.e. information acquired within an organization where research is being carried out. Various options of panel data regression were done, fixed effects, random effects and OLS panel. And the results were presented in tables.

The study found that Q-ratio of all the companies were below 1. Since the Tobin's q is less than 1, then the market value is less than the recorded value of the assets of the company which suggests that the market may be undervaluing the banks. The study found that there was a variation Tobin Q over the previous year and they were not consistent at the end of the year according to their performance. This study concludes that board size negatively affects firm's market performance while board composition affects market performance positively the most and a unit increase in executive remuneration has the least positive influence. The study recommends that for banks to have better market performances should adopt better corporate governance practices since corporate governance practices affects the market performance of the banks positively.

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## ABBREVIATIONS

<b>BOD</b>	<b>Board of Directors</b>
<b>CEO</b>	<b>Chief Executive Officer</b>
<b>CMA</b>	<b>Capital Market Authority</b>
<b>NSE</b>	<b>Nairobi Stock Exchange</b>

## CHAPTER ONE

### 1.0

### INTRODUCTION

#### 1.1 Background to the Study

Corporate governance practices, principles and structures have recently gained popularity in developing world. Corporate governance specifies the rights and obligations of the various claimants on the cash flow of big enterprise. Corporate governance issues arise because of the existence of agency problems that cannot be resolved through contractual solutions due to high transaction costs (Petra, 2005). These agency costs manifest themselves in the form of conflict between investors and other claimants on cash flow on one hand, and the managers and the directors who have the discretion over the cash flow are used, on the other. This follows from the dominant model of corporate governance in law and economics which considers a corporation as a compelled web of contractual relationship among the various claimant to the cash flow of enterprise. Claessens *et al* (2002) maintain that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favorable treatment of all stakeholders.

Among the many claimants on firm's cash flows, equity shareholders have always claimed a special attention may be because of the residual nature of their claims. Parker (2007a) paradigm of the separation of share holder ownership and management's control explained that agency problem occurs when the principal (Shareholders) lacks the necessary power/information to monitor and control the agent (manager) and when the compensation of the principal and the agent is not aligned.

Given the existing problem inherent in the corporate firm, performance will be function of the quality of the corporate governance structures of the company (McKinsey and Co. 2005). In an efficient capital market, investors will discount the price they are willing to pay for a company's shares by the expected level of managerial agency costs. It is therefore assumed

that for a company to prosper it will choose a corporate governance that is efficient in minimizing agency costs. It has also been argued that in the end it is a country's political framework which determines the quality of its corporate governance practices (Roe, 2003).

Corporate governance is defined as a field in economics that investigates how to secure or motivates efficient management of corporations by the use of incentives mechanism, such as contracts, organization design and legislation (Mathiesen, 2002). Abor, (2007) defines corporate governance as the system by which companies are directed and controlled. It also refers to as the way in which corporations are handled by corporate boards and officers. Hampel (1998) observes that good governance ensures that stakeholders with the relevant interest in the company business are fully taken into account. Brown and Caylor (2004) also shares the foregoing views seeing corporate governance as the relationship among various participant in determining the direction and performance of the companies consistent with the public good.

Corporate governance can be defined as the set of institutional arrangements affecting corporate decision making (Carter and Lorsch, 2004). Evans and Loh (2002 p.1) describe corporate governance as “ rules governing board structures, managers and board’s incentive compensation, decisions rights by the board and the Chief Executive Officer (CEO), session of the board and Chief Executive Officer, shareholding voting, debt/equity finance decisions as well as disclosure during take-over.

During the last decade, the study of original decline and turn around has been the subject of renewed interest. In their paper on corporate failures, Gemmill and Thomas (2004) reported that annual failure rate of large U S firms grew from 1% during 1967 to 1982 period to over 3% since 1985. In Kenya, Wambua (2003) documented in general, the actions taken by companies facing rapid performance declines, he reported that employee lay-offs was popular and was taken by 60 % of the companies sampled.

Mululu (2005) carried out research on corporate governance structures and performance on all listed firms in the stock exchange. He found that board activity is related to a number of

corporate variables such as board size, the number of executive directors, the number of shares held by largest shareholders, number of shares by unaffiliated block holders, and the number of other directorships held by outside directors. He reported that board increase the frequency of their meetings during financial crises.

Statistics indicates that successful turnaround is difficult to achieve and the probability of failure is high for firms going through decline. Although corporate governance has long been considered as an important aspect of corporate control, it is only in recent years that researchers have become directly concerned in the study of alternative governance structures and their impact on performance. Several aspects of corporate governance including the form of executive pay and their composition of boards have been found to be associated with firm's strategic decisions and performance. An examination of firms in decline provides an ideal forum to analyze governance elements. Firms in decline face greater shareholders scrutiny and, it is speculated that they are more likely to respond to this scrutiny with changes to their governance structures.

### **1.1.1 Corporate Governance Structures**

Corporate governance structures can be defined as the systems or mechanisms designed to monitor managers and improve corporate transparency (Tsui and Gui, 2000). Typically corporate governance structures adopted by firms experiencing declining performance results in changes in; board meeting frequency (Klapper and Love, 2003); board composition (McCord, 2002) insider share ownership (Morck, Shleifer, and Vishny, 1998); and executive compensation (Monks and Minow, 2004). Board meeting frequency potentially carries important governance implication as it is less costly for a firm to adjust the frequency of its board meeting to attain better governance of the firm, than to change the composition of its board or ownership structures. Vafeas (1999) found that meeting frequency was influential in improving operating performance in a manner consistent with the agency theory.

Studies on firm performance as a function of board composition yield mixed results (Baysinger and Butler, 2005). MacAvoy and Millstein (2003), for example, found that the

proportion of outside directors is significantly lower on boards of banks in state that restrict banking acquisitions, suggesting that outside directors play a role in evaluating takeover proposals. Weisbach reports that CEO turnover is more highly correlated with firm performance in corporations having a majority of outside directors than firms that have predominantly insider board. Further, Hermalin and Weisbach (1998) find that outsiders are more likely to join a board after a firm performs poorly or leaves an industry. Once inference may be the need for additional outside guidance in companies undergoing strategic shifts.

Abor (2007) commented that where managers hold little equity in the firm and the share holders are too dispersed to enforce value maximization, corporate assets may be deployed to benefit managers rather than shareholders. According to MacAvoy and Millstein, (2003) the costs of deviation from value maximization decline as management ownership rises because of converging interests. Consistent with the above, Mak and Yuanto (2003) found an inverted U- shaped relationship between Tobin's Q and managerial ownership. Numerous studies have identified a positive relationship between executive compensation and firm performance although debate continues as to the exact size of this function.

### **1.1.2 Commercial Banking Industry in Kenya**

The Banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act, and the various prudential guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalised in 1995 and exchange controls lifted. The Central Bank of Kenya, which falls under the Ministry of Finance, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. Central Bank of Kenya publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines

Banks represent a significant and influential sector of business worldwide that plays a crucial role in the global economy. Commercial banks are financial intermediaries that serve as financial resource mobilization points in the global economy. They channel funds needed by

business and household sectors from surplus spending to deficit spending units in the economy. A well developed efficient banking sector is an important prerequisite for saving and investment decisions needed for rapid economic growth. A well functioning banking sector provides a system by which a country's most profitable and efficient projects are systematically and continuously funded. The role of banks in an economy is paramount because they execute monetary policy and provide means for facilitating payment for goods and services in the domestic and international trade.

## **1.2 Statement of the Problem**

The association between quality of corporate governance structures and firms' profitability is quite major focus in corporate governance studies, but one cannot predict much on the direction as prior literatures show mixed results. Jensen and Meckling (1976) have proven that firms with better governance structures might have more efficient operations, resulting in a higher expected future cash-flow stream. Klapper and Love (2003) that use return on assets as measure for performance found evidence that firms with better governance structures have higher operating performance. Contrast results are seen in Gompers *et al.* (2003) who found no significant relationship between firms governance structures and operating performance. Eisenberg *et al.* (1998) also find negative correlation between board size and profitability when using sample of small and midsize Finnish firms. According to Cho and Kim (2003), company would enhance their corporate governance structures when the company's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance.

Recent scandals, such as the city group's \$8 billion scandal in generated charges, have focused attention on corporate governance issues in the financial sector. This has increased awareness of agency problems in the banking industry leading to the question of whether corporate governance matters, in a regulated environment, like the banking industry (Capiro and Levine, 2002). It is important to understand corporate governance in banks for several reasons. When banks efficiently allocate funds, it lowers the cost of capital to firms,

enhances capital formation, and stimulates growth in the economy (Levine 2004). The stability of financial system serves a broad role in the economic development and bank failure can reverberate with strong negative implications.

Kenyan banks have in the recent past experienced a number of corporate failures related to corporate governance structures in place. In 2007, Charter bank was placed under statutory management amidst suspicions of money laundering and fraud. Corporate failures are usually preceded by financial hardship and declining firm performance. These are the tell-tale signs that should provoke the management to take immediate remedial action before the actual failure happens. In general, successful turnarounds are rare in Kenya, which begs the question whether or not proper and timely response are employed by the board when the first signs of impending trouble are detected.

This study will differ from that done by Mululu (2005) in one important aspect. While he considered all the listed companies, this study will only concentrate on quoted banks in Kenya in the financial sector of the Nairobi stock exchange. Banks are considered more sensitive as they hold depositors monies, and for their effect or role on Kenya's economy in regulating the amount of money supply.

Other prior research on corporate governance in Kenya focused mainly on compliance with the principles of the best practices, and survey of the state of governance in various sector, Jebet (2001) documented the corporate governance structures in listed companies. None of these studies have focused on the relationship between corporate governance structures and financial performance of Banks listed in Nairobi Stock Exchange (NSE). The aim of this research was to establish the relationship between the performances of Banks listed in Nairobi Stock Exchange (NSE) and their corporate governance structures.

### **1.3 Objective of the Study**

To determine how corporate governance structure affect performance of banks

## 1.4 Research Questions

- i) Is there a positive relationship between bank performances of the preceding year and frequency of board meetings?
- ii) Is there a positive relationship between the bank performances and the percentage of Institutional investors share ownership.
- iii) Is there a positive relationship between executive compensation and bank performance?
- iv) Is there a positive relationship between the ratio of outside directors to total directors and Banks' performance?

## 1.5 Importance of the Study

The study will have implications for:

**Academicians and researchers:** the results of the study should serve as a point of departure for further investigations in governance structures and systems for academics and researches in general. This study will be an eye opener in research in developing markets.

**Regulators of financial markets:** the study will help regulators of the banking industry to identify the crucial aspects of corporate governance structures that should be emphasized in the governance matrix. Given the many scams and financial fraud reported in many corporations and the vast sums of wealth of shareholders destroyed thereby, findings of the study should help regulators play their role effectively.

**Management and boards of banks:** The study will be of benefit to management boards of listed and unlisted banks by giving guidelines on the key value aspects of corporate governance structures. Boards act on behalf of shareholders, endeavoring always to report comprehensively, accurately and on a timely basis. This study would go some way in helping them play their oversight role.



## **CHAPTER TWO**

### **2.0**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. The specific areas covered here are concept corporate governance structures including board composition, executive compensation, board meeting frequency, large block holders, insider share ownership, take-over and large creditors (debt financing); relationship between corporate governance and firm performance and measures of firm performance.

#### **2.2 Concept Corporate Governance Structures**

The corporate governance structures have been of great importance when determining the value of the firm. It has been argued and debated that firms (banks) that practice good governance have reported increased wealth or value.

In Kenya, the Centre of Corporate Governance and the Capital Market Authority as well as the provisions of the Banking Act (chapter 488) make provisions for publicly listed companies in Kenya to comply with corporate governance best practices which involve sound corporate governance structures. The Central Bank of Kenya together with the Nairobi stock exchange has set corporate governance guidelines for listed banks to comply with (CBK annual report 2007).

The Basel Committee on Banking Supervision (1999) state that from the banking perspective , corporate governance involves the manner in which the business and affairs of individual institution are governed by their board of directors and senior management, affecting how banks set corporate objectives; run the day to day operation of the business; consider the interest of recognized stakeholders; align corporate activities and behaviors with the

expectation that the banks will operate in safe and sound manner, and in compliance with the applicable laws and regulations and; protect the interest of the depositors.

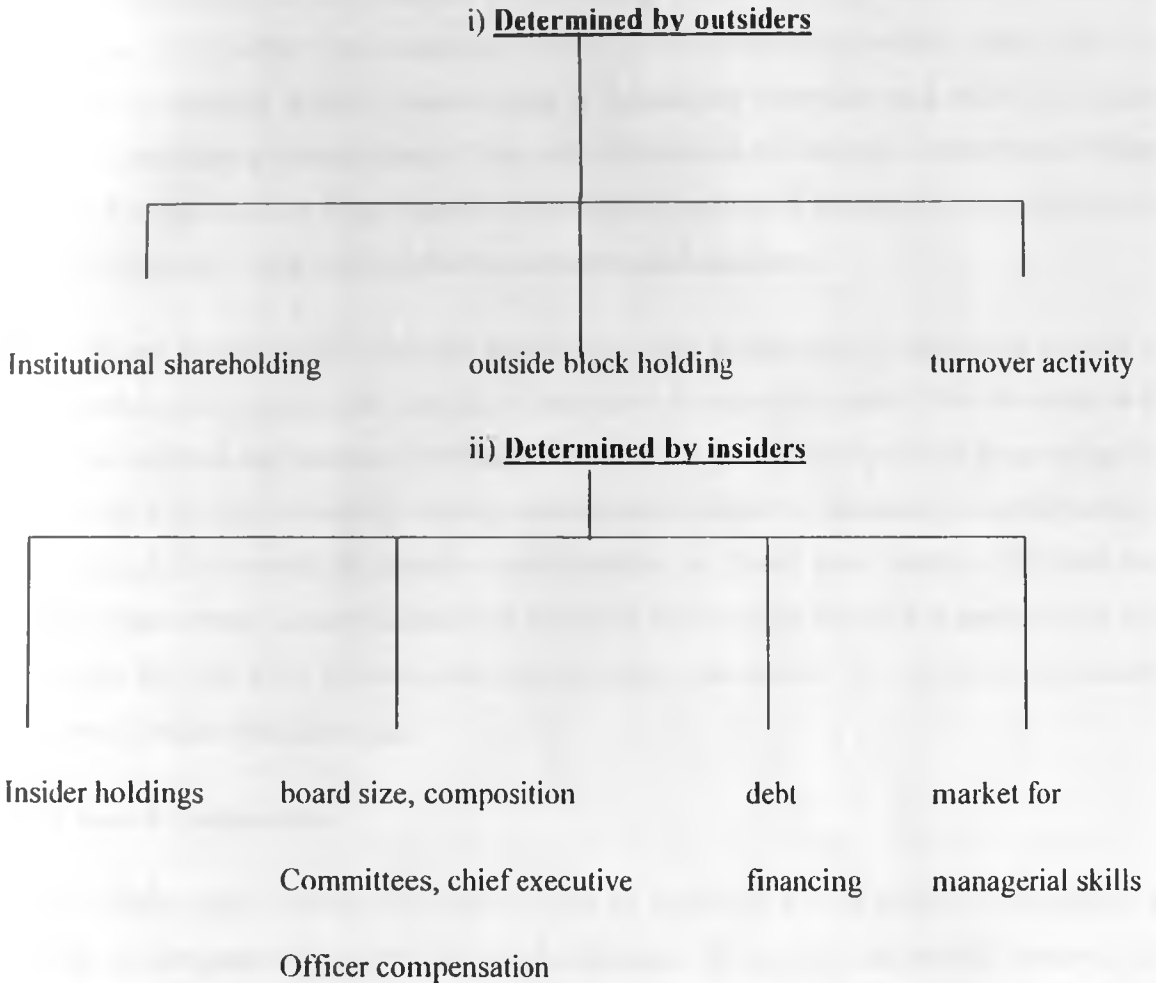
King and Levine (1993a and b) and Levine in a report (Corporate Governance in listed companies, 1997) emphasized the importance of corporate governance in the banks for the following reasons; Banks have a dominant position in developing economy financial systems, and are extremely important engine of economic growth; as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms; as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for economy's savings; many developing economies have recently liberalized their banking systems through privatization/disinvestment and reducing the role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.

The subject of corporate governance which is well developed in the concept of agency theory ,as expounded by Jensen and Meckling (1976), ensures that systems are put in place to not only ensure management does not act in their own selfish interests. It also endeavors to ensure maximization of the shareholders value.

Jensen and Meckling (1976) applied the logic of agency theory to issues of minimizing the intra-corporate conflicts, while at the same time taking cognizance of the role the political process plays in resolving potential complications, by focusing on the important concept of exploiting self – interest in the attainment of corporate goals.

Listed banks just like any listed company have governance structures that can be used to change the performance of such firms. According to Tsui and Gul (2000), corporate governance structures are designed to monitor managers and improve corporate transparency. A number of corporate structures have been identified analytically and empirically.

According to Agrawal and Knoeber (1996), the structures may be broadly classified as internal and external as summarized below:



**(Source: Adaptation from rendering of Agrawal and Knoeber, 1996 classification)**

Agrawal and Knoeber (1996) identified seven control structures for the shareholders and management agency conflict. The control structures were divided into two namely; internal and external i.e. the internal, means the internal decision makers while external referred to outside partners.

Further, the structures can be distinguished by the source of monitoring that takes place. The use of debts is internally determined and relies on the capital market for monitoring. On the other hand, market for the manager are externally determined and relies on prospective employers; the market for corporate control is determined externally and relied on prospective acquires; insider shareholdings is determined internally and relies on insider owners ; institutional shareholding is externally determined and relies on institutional owners ; block holding relies on large outside shareholders ; and use of outside directors and on the board is internally determined and relies on these board members .

Agrawal and Knoebe (1991) consider control structures as alternatives, which can be used in substitution. This implies that the use of structures is negatively related but the relation is possible. Agrawal and Knoebe (1991) give example of greater insider holdings assisting the market for corporate control by making insiders less obstructive. Similarly corporate control activity can be boosted by outsider representation on board since outside directors can facilitate take-overs. Greater institutional and block holding may reduce transaction costs and eliminate the free rider problem and thus facilitate take-overs. The common governance structures include the following:

### **2.2.1 Board Composition**

Fama (1980) argued that for the board to play its oversight role of effective monitoring, it should be composed of majority of outside directors. He argued that outside directors will exhibit considerable independence from top management. Mace (1971) reported that poor proposals or performance will be opposed by outside directors. Weishach (1998) found out that outside dominated boards are significantly likely to respond to poor performance by dismissing the chief executive officer. Brickley et al (1991) also find evidence that outside directors' act on in the shareholders interest in their decision in the adoption of the poison pill provision. Brickley and James (1987), further, found that the proportion of outside directors is significantly lower on boards of banks in state that restricts banking acquisitions.

Weisbach and Hermalin (1998) found that outsiders are more likely to join the board after the firms performs poorly or leaves an industry, reflecting the need to inject new blood to procure expertise in the new industry. Both Coughlan and Schmidt (1995) and Warner , Watts, and Wruck (1998) examine the extent to which board discipline managers found out that poor firm performance increases the likelihood of change in top management team. However, the relationship between firm performance and CEO turnover has been found to be fairly weak (Jensen and Murphy, 1990; Hermalin and Weisbach, 1998).

In the Jebet (2001), he carried out a research on how the corporate governance structures affect the firm performance (listed). Board composition was noted to be a quality/ fixation of firm performance. He sampled the various listed companies in the Nairobi Stock Exchange and found that the firms with high number of outside directors performed well as compared to those with less representation from outside directors. This study seeks to verify if the bank's performance is related to outside directorship.

### **2.2.2 Executive Compensation**

Owing to the problem of separation of ownership and management; the agency theory argues that in the modern corporations, where ownership is dispersed and managers have access to superior information, managers typically end up with residual rights of control, giving them enormous latitude for self – interested behavior. In order to counter such pursuits, one way is to grant managers a highly contingent, long-term incentive contracts ex-ante to align his interest of investors. Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Fama, 1980). The optimal incentive contract is determined by manager's risk aversion, the importance of his decisions, and his ability to pay the cash flow ownership upfront (Stiglitz, 1975; Homstrom, 1982)

Jensen and Murphy (1990) arrived at a striking number that executive pay rise by about \$3 per every \$1000 change in the wealth of shareholders. Kaplan (1994) showed that the sensitivity of pay (and dismissal) to performance is similar to all companies in the united state .Several studies have identified a positive relationship between executive pay and firm

performance. Evans and Stormback (1994), and Izan, Sidhu, and Taylor (1998) both supported a positive pay –performance relationship.

### **2.2.3 Board Meeting Frequency**

Jensen (1993) argues that boards of well run companies should be relatively inactive and exhibit few conflicts. Frequently scheduled meetings generate opportunity costs in the form of management time consumed, and cash costs in form of traveling allowances and sitting allowance fee for the board members. Yet real benefits can be derived from such meetings as directors have an opportunity to confer, set strategy and monitor management. Vafeas (1999), for instance found that meeting frequency was influential in improving operating performance in a manner consistent with the agency theory.

Mululu (2005) shows that board increase the frequency of their meeting following poor performance and consequence of such increase the performance of firm improves as captured by the increase in firm value giving support to Jensen (1993) and Vafeas (1999) that the role boards becomes increasingly important during crises, when share holders' interest are in visible danger. However, the association between meeting frequency and firm value remains unclear, and the linkage between the board activity and monitoring difficult to establish.

### **2.2.4 Large Block Holders**

The most direct way to align cash flow and control rights of outside investors is to concentrate share holdings. This can mean that one or several investors in the firm have substantial minority ownership stakes, such as 10 or 20%. A substantial minority shareholder has the incentive to collect information and monitor the management, thereby avoiding the traditional free-rider problem. He also has enough voting control to put pressure on the management in some cases, or perhaps even to oust the management through a proxy fight or a take-over (Shleifer and Vishny, 1986). Large shareholders thus address the agency problem in that they both have a general interest in profit maximization, and control over the asset of the firm to have their interest respected.

Evidence on the role of large shareholders in exercising corporate governance is commencing to accumulate. According to Germany, Kaplan and Minton (1994), large shareholders are associated with higher turnover of directors. Japan, Kaplan and Minton (1994) established that firm with large share holders are most likely to replace managers in response to poor performance than firms without them. In United States, Shivdasani (1993) showed that large outside shareholders increase the likelihood that firm is taken over.

Claessen *et al.* (2002) found that firm value increases with the cash-flow ownership of the largest shareholder, consistent with a positive incentive effect, for their sample of publicly trade firms in eight East Asian economies in 1996. However, firm value falls when control rights exceeded cash-flow rights for the dominant shareholder (entrenchment effect). Finally, they find that the separation of ownership and control in general, and not any mechanism in particular (pyramidal structures, dual –class shares, cross-holdings) is responsible for value discount.

### **2.2.5 Insider Share Ownership**

Berle and Means commented that where managers hold little equity in the firm and the shareholders are too dispersed to enforce value maximization, corporate assets may be deployed to benefit managers rather than, shareholders. Managers in such situations may shirk, consume large amount of perquisite, engage in empire building or make sub optimal investment and distribution decisions. To induce management not to engage in opportunistic behavior, measures need to be taken to align their interests with those of shareholders by making them part owners of the firm (Jensen and Meckling, 1976).

Morck, Shleifer and Vishny (1998) estimate a piecewise linear relation between board ownership and performance as measured by Tobin's Q and finds that Tobin's Q increases with managerial ownership. Klein (1998) finds evidence that equity holdings are positively correlated to firm performance where at least one outside director owns 2% of the firm equity. Mallette, Middlemist and Hopkins (1995) argue that 'active defense of shareholders'

interest may depend on the existence of directors whose personal interest compels them to actively monitor management activities.

Hermalin and Weisbach (1991) also noted a non-linear effect of insider shareholdings in the course of an analysis of the board composition on firm performance. While these findings are mixed, the weight of the evidence implies that firms perform better when managers own a non-trivial fraction of the firm's shares.

In Lins (2003) management group own on average 30% of firms and are the largest block holders in 2/3 of their sample, while non-management block holder owns 20% of voting rights. He uses a cross sectional sample of 1433 public firms from 18 emerging markets, for year 1995. For robustness tests he uses a two simultaneous equation model to account for endogeneity between ownership and firm value (firm value is lower as a result of expected costly agency problems/ if a manager expects lower cash-flow he would tend to increase the discrepancy between his voting rights and his cash-flow rights). He finds support for the managerial entrenchment hypothesis and concludes that the costs of the private benefits of control are capitalized into share prices in emerging markets. Additionally, he finds evidence that large non-management block holders can reduce the valuation discount associated with expected managerial agency problems as a partial substitute for missing institutional governance mechanisms. He also shows that firm value declines as the separation of management group control and cash-flow rights gets larger.

### **2.2.6 Take-Over**

Takeover can be defined as 'rapid fire mechanism for ownership concentration' (Shleifer and Vishny, 1999). In a typical hostile takeover, a bidder makes a tender offer to the dispersed shareholders of the target firm, and if they accept this offer, acquires control of the target firm, and so can replace, or at least control, the management.

Substantial theory and evidence supports the idea that takeover address governance problems (Jensen 1998; Scarfstein, 1998). Palepu (1985) shows that takeover target are often poorly



performing firms and their managers are removed once the takeover succeeds (Martin and Mc Connell, 1991). Jensen (1998) argues takeover can solve the free cash flow problem, since they are usually lead to distribution of the firm's profit to investors over time. Takeovers are widely interpreted as the critical governance structure in the USA, without which managerial discretion cannot be effectively controlled (Easterbrook and Fischel, 1991; Jensen, 1993).

### **2.2.7 Large Creditors (Debt Financing)**

Significant creditors have large investment in the firm, and want to see returns on their investment materialize. Their power comes in part because of a variety of control rights they receive when firm defaults or violate debt covenants (Smith and Warner,1979) and in part because they typically lend short term, so borrowers have to come back at regular short intervals for more funds.

Diamond (1984) presents one of the first models of monitoring by the large creditors. Kaplan and Minton (1994) documents the higher incidence of management turnover in response to poor performance in companies that have a principal banking relationship relative to companies that do not. Delong (1991) points to a significant governance role played by Morgan partners in the companies Morgan invested in the early 20<sup>th</sup> century.

Weir, Laing and McKnight (2002) hypothesizes that debt financing is an internal governance structure whereby increased debt reduces free cash flow and so limits managerial discretion. Debt requires managers to use any excess funds to service company's debt rather than engage in negative net present value project.

## **2.3 Relationship between Corporate Governance and Firm Performance**

Many other researchers have examined the relationship between variety of governance mechanisms and firm performance. However, the results are mixed. Some examine only the impact of one governance mechanism on performance as Himmelberg et al (1999) did, while others investigate the influence of several mechanisms together on performance. None of

them covers a complete set of governance mechanism. Below, we will briefly review some of previous studies on the governance- performance relationship.

### Board Composition

It is suggested that higher proportion of non- executive directors in the board helps to reduce the agency cost. Kee at al (2003) and Hutchinson and Gul (2003) support this view by showing that higher level of non-executive directors on the board weakens the negative relationship between the firm's investment opportunities and firm's performance. However, de Jong et al. (2002), Coles et al (2001), and Weir et el. (2002) dispute it by stating that there is no significant relationship between non-executive directors' representation and performance. In contrast, in the UK, Weir and Laing (2000) find a negative relationship between non-executive director representation and performance. In addition, Yermack (1996) present that small boards have a higher market valuation.

Stronger support for the positive impact of non-executive directors comes from event study analysis. The studies by Rosenstein and Wyatt (1990 and 1997) and Shivdasani and Yermack (1999) show that the appointment of non-executives directors increases company value.

### Leadership Structure

Although UK Code regards separation of the role of CEO and chairman as a sign of good governance, previous empirical analyses (200) do not find any significant relationship between CEO duality and performance. Brinkley et al. (1997) observe that costs of separation are larger than benefits for most large U.S. firms.

## 2.4 Measures of Firm Performance

Several metrics are available for measuring the creation or destruction of shareholders value. Four of the mostly used metrics are Tobin's Q, Total shareholder Return Index (TRI), Economic Value Added (EVA), and Cash Value Added (CVA).

**Tobin's Q:** This is the second measure applied in the measurement of a firm financial performance.

Theoretically, if a firm's investment opportunities earn a rate of return,  $r$ , equal to its cost of capital,  $k$ , (i.e.  $r=k$ ), Tobin's Q ratio would be 1.0. That is, investors are indifferent in their expectations regarding the firm's growth opportunities. However, if  $r$  is greater than  $k$ , Tobin's Q would be greater than 1.0 indicating that the investors have a positive outlook for the firm's future growth opportunities. The market prices of a firm's shares are based on management's ability to generate sustainable real returns on investments that exceed firm's real discount rate.

Tobin's Q compares the market value of the firm with the replacement costs of the assets implying that the greater the real return on investments the greater the value of Q. In contrast to the book-to-Market (B/M) ratio, the impact of inflation is mitigated in the Q calculation by the use of the replacement cost of assets measured in constant shillings to measure the value created by the firm. The attractiveness of the Q ratio results from its ability to provide the estimate of a firm's intangible assets such as the goodwill, future investment opportunities, market power and quality of management. Ranking firms on their Q values is similar to ranking them on the basis of changes in expected future cash flows.

**Total Return Index (TRI):** The index is a measure of the combined capital gain and dividend yield to investors. TRI is driven by a firm's free cash flow, asset growth and changes in profitability, all of which are prime determinants of firm's performance. TRI is constructed using an annualized yield as follows (see Evans, and Loh, 2002).

**Economic Value Added:** This model was popularized by Stern Stewart & Company and is based on a company's accounts. Its mechanism which is accounting based simplifies to the following relationship:

$$\text{EVA} = \text{Sales} - \text{Operating expenses} - \text{Tax} - \text{Financial requirements}$$

Where “Financial requirements” is calculated as defined capital multiplied with a suitable weighted average cost of capital (WACC)

Stewart has identified several errors made in Accounting from investors’ perspective. He advises that the errors be adjusted to stimulate cash flow .Examples of situations requiring adjustment are inventory costing and valuation , depreciation, revenue recognition, and capitalization and amortization of R&D, marketing ,restructuring charges and acquisition premiums.

**Cash Value Added (CVA).** Cash value added represents value creation (destruction) from the shareholders point of view. Weissenrieder (1997) expresses it as an index as follows;

$$\text{CVA index} = \text{Operating cash flows} / \text{Operating cash flows demand arg}$$

Weissenrieder splits CVA index into four margins (in relation to sales)

$$\text{CVA Index} = \frac{\text{operating surplus margin} - \text{Wmargin} - \text{non strategic investment arg in}}{\text{Operating cash flows demand arg in}}$$

## CHAPTER THREE

### 3.0 RESEARCH METHODOLOGY

#### 3.1 Research Design

The research was conducted using a Cross-sectional survey that sought to identify differences in corporate governance's structures between listed banks facing a decline in values and those with appreciating values, and those with stable value on calendar years 2003, 2004, 2005, 2006, 2007 and 2008.

The study used four governance structures favored by banks in sustained financial crises as earlier mentioned which include: frequency of board meeting, board composition, insider share ownership and executive compensation.

#### 3.2 Population and Sample

The study targeted all listed banks in Kenya for the period of five years (2002 to 2007). All the listed banks (nine in number) in the stated period were studied as highlighted in the appendix 1.

#### 3.3 Data Collection

In order to establish the relationship between corporate governance structure and the performance of banks listed on the Nairobi Stock Exchange, secondary data sources were used where by internal secondary research i.e. information acquired within an organization where research is being carried out. Secondary data is information gathered for purposes other than the completion of a research project while secondary data research is the research which is based on gathering the information from the findings of other researchers (Steppingstones, 2004). Secondary data collection has the advantage of being less expensive and less time consuming.

Data was derived from the annual reports of the banks listed in the NSE and their books of account. Past five years information of the banks was collected on number of board meetings held in the year, board size, board composition, insider share ownership and executive composition.

### **3.4 Data Analysis and Presentation**

#### **3.4.1 Variable Definition**

Several metrics are available for measuring creation or destruction of shareholder value. The most commonly used metric include discounted cash flow (DCF), Return on investment capital (ROIC), Tobin's Q, Total shareholder Return Index (TRI), Economic Value Added (EVA), and Cash Value Added (CVA). The study will employ Tobin Q as proxy for financial performance.

#### **Computation of Tobin's Q**

To compute values for Q, where Q is defined as the market value of firm divided by the replacement costs of the firm's assets, the methodology of Vogt (1994) was followed by first defining the variables as follows:

Market Value of Firm = Market Value of Ordinary Shares + Market Value of Preference Shares + Book Value of Debt

Replacement Cost of Assets = Replacement Value of Plant and Equipment + Replacement Value of Inventory

Various options of panel data regression were done, fixed effects, random effects and OLS panel. And the results presented in a table. The panel character of the data allowed for the use of panel data regression equation/model. Panel data involved the pooling of observations on a cross-section of units over several time periods and provides results that are simply not detectable in pure cross-sections or pure time-series studies. A general model for panel data that allowed the researcher to estimate panel data with great flexibility and formulate the

differences in the behavior of the cross-section elements were adopted. The panel regression equation differs from a regular time-series or cross section regression by the double subscript attached to each variable. Data to be collected was analyzed using two approaches:

i) Descriptive statistics: to compute loser's vs. winners over the test period for all the governance variables. Test for significant difference in the means for the two groups were computed. This provided evidence (or otherwise) to hypothesis relationship between corporate governance structures and decline in bank value. For example:

“Whether board meetings in distressed banks are more frequent.

“Whether outside directors make a bigger proportion of distressed banks boards.

“Whether insider ownership rises for distressed banks.

“Whether executive compensation is lower for poorly performing banks.

The Tobin's Q (or book to market ratio) for all listed banks were computed at the end of calendar years 2002, 2003, 2004, 2005, 2006, 2007. Beginning at the end of year 2003, all listed banks at Nairobi Stock Exchange were sorted into three groups based on their movement in their values over the preceding two years. The groups were designated as: **Losers:** which comprised stock of banks with negative variation in the performance metric over the previous year; **Winners:** comprising banks with the variation in the performance metric over the previous year; **Mixed:** where the direction of variation over the previous year was not consistent at the end of the year according to their performance. The sorting were repeated at the end of 2004, 2006 and 2007.

For the cohort to be formed at end of 2003, corporate governance structure was investigated as evident in 2004; for the cohort to be formed at end of 2004, relevant governance was documented at end of 2005; for cohort of 2005 governance was investigated at end of 2006; and lastly the cohort to be formed at end of 2006, structures at end of 2007 was established. In sum, consequence of two consecutive year's performance was studied one year later. The

resulting data on the four cohorts was sorted into three categories of WINNERS, LOSERS and MIXED. The cohort was consolidated so that only those classifications of “LOSERS”, “WINNERS”, and “MIXED” were left. The purpose of this was to look for banks that were experiencing declining performance for a period of time i.e. whether there was a bank that had reported negative performance for two consecutive periods. For such banks, the study sought to test the probability that a certain corporate governance action was taken in the third year.

- ii) Regression analysis was then applied to cross check the conclusion reached in the first approach. A regression model relating each of the four corporate governance structures to value of the bank as proxied by Tobin’s Q and Book-to-market ratio was specified.
- iii) To test hypothesized relationship between performance and frequency of Board Meetings Model

$$\text{Log (meetings)}_{it} = \alpha_{it-1} + \beta_1 Q_{it-1} + \beta_2 \text{log (Board size)}_{it-1} \dots\dots\dots \text{Eqn.2}$$

Where:

$\text{Log (meetings)}_{it}$  = log of number of meetings held in year t

$Q_{it}$  = Tobin’s Q of bank i for year t.

$\text{Log (board size)}_{it}$  = log of board size.

- iv) Classified into three i.e. < 40% = insider dominated

Non-executive directors > 60% = outsider dominated

Between 40-65% = mixed board

To test Board Composition and bank performance ( $H_2$ ).



$$Q_{it} = \beta_1 + \beta_2 \log(\text{outside})_{it-1} \dots \dots \dots \text{Eqn. 3}$$

Where  $Q_{it}$  = Tobin's Q of Bank i for year t.

$\log(\text{outside})_{it-1}$  = Ration of outside non-executive directors to the total No. of directors lagged one year.

- v) To test of relationship between the percentage of insider share ownership and bank performance ( $H_3$ ), a step wise linear regression for each year as described by Morck et al, (1998) was estimated by

$$Q = \beta_1 \log(a) + \beta_2 (\log b) + \beta_3 (\log c) \dots \dots \dots \text{Eqn. 4}$$

Where Q= Tobin's Q

$\beta_1$  = coefficient that capture the effects of insider ownership < 5%

$\beta_2$  = coefficient that capture the effects of insider ownership 5% < 25%

$\beta_3$  = coefficient that capture the effects of insider ownership > 25%

- vi) Least square regression will be used to test the relationship between executive remuneration and bank performance ( $H_4$ ). The model equation five.

$$(\text{CEO Rem})_{it} = \beta_1 Q_{it} + \beta_2 (\text{Revenue})_{it} \dots \dots \dots \text{Eqn. 5}$$

Where:

$(\text{CEO Rem})_{it}$  = Log of executive remuneration (Salary + Bonus)

$Q_{it-1}$  = Tobin's Q

$(\text{Revenue})_{it-1}$  = log of annual revenue.

## CHAPTER FOUR

### 4.0 DATA ANALYSIS, INTERPRETATION AND PRESENTATION

#### 4.1 Introduction

This chapter presents the data findings and analysis there-to on the relationship between corporate governance structures and performances of commercial banks listed at the NSE. The study targeted all the commercial banks that had consistently operated from 2003 to 2008. Although there were 9 commercial banks listed at the NSE, only six were considered. This is because Corporate Bank Limited and Equity Bank were listed in late 2008 and 2006 which technically makes them inappropriate for this study. CFC/Stanbic bank was also not considered following the merger of CFC Holdings Ltd and Stanbic Bank Ltd within the study period which would bring inconsistency in the analysis since before 2008 they operated as two entities.

#### 4.2 Commercial Banks Performance as indicated by the Tobins Q and Price-to-Book Value

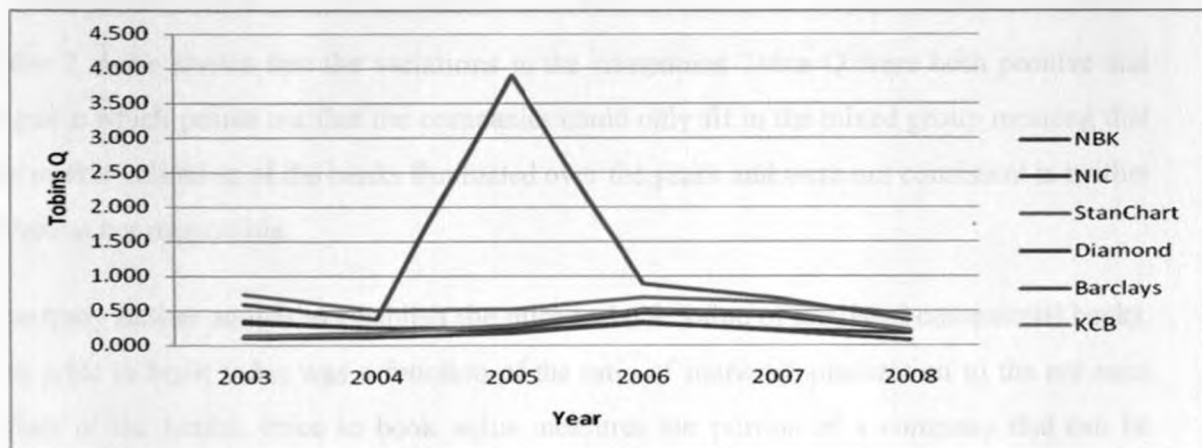
To determine the commercial banks' performance during the study period (2003 to 2008) the study calculated their Tobin Q ratio using market value of firm calculated as their market capitalization divided by the replacement costs of the firm's assets, that is, asset value of the banks and the data findings presented in the table below.

**Table 1: Tobins Q of Commercial Banks in Kenya**

Bank	2003	2004	2005	2006	2007	2008	Mean	Min	Max
NBK	0.1030	0.1236	0.1765	0.3211	0.2258	0.1827	0.1888	0.1030	0.3211
NIC Bank	0.3412	0.2476	0.2002	0.3225	0.1976	0.0725	0.2303	0.0725	0.3412
Stan Chart	0.7366	0.4944	0.5190	0.6882	0.6148	0.4422	0.5825	0.4422	0.7366
DTB	0.3204	0.2492	0.2445	0.4661	0.4280	0.2033	0.3186	0.2033	0.4661
BBK	0.5901	0.3837	3.9087	0.8882	0.6804	0.3626	1.1356	0.3626	3.9087
KCB	0.1338	0.1835	0.2880	0.5199	0.4722	0.2140	0.3019	0.1338	0.5199

According to table 1 above, the Q-ratio of all the companies were below 1. Since the Tobin's q is less than 1, then the market value is less than the recorded value of the assets of the company which suggests that the market may be undervaluing the banks. Among the banks, Barclays banks of Kenya has the highest Q-ratio which stands at 1.1356, followed by standard chartered bank at 0.5825, then diamond trust bank at 0.3186, KCB at 0.3019, NIC Bank Ltd at 0.2303 and lastly National Bank of Kenya at 0.1827. However, only Barclays bank of Kenya had a Q-ratio which was more than 1 in 2005 (3.9087) suggesting that in that year market value was greater than the value of the company's recorded assets. The same is presented in the figure below:

**Figure 1: Tobins Q of Commercial Banks in Kenya**



Taking a look at the variations in the Q ratio so as to group the banks into 3 groups: losers, winners and mixed. Losers comprise of banks with negative tobin Q variation over the previous year; winners comprise of banks with positive variations in the performance metric over the previous year while mixed comprise of banks whose direction of Tobin Q variation over the previous year will not be consistent at the end of the year according to their performance.

**Table 2: Variations in the Tobin Q**

Bank	2003	2004	2005	2006	2007	2008	STDEV	Group
NBK	-	0.0205	0.0529	0.1447	-0.0954	-0.0431	0.0783	Mixed
NIC	-	-0.0936	-0.0474	0.1224	-0.1249	-0.1251	0.0980	Mixed
Standard Chartered	-	-0.2422	0.0246	0.1692	-0.0734	-0.1726	0.1161	Mixed
Diamond	-	-0.0713	-0.0047	0.2216	-0.0381	-0.2247	0.1071	Mixed
Barclays	-	-0.2065	3.5250	-3.0205	-0.2077	-0.3178	1.3725	Mixed
KCB	-	0.0498	0.1045	0.2319	-0.0477	-0.2582	0.1592	Mixed

Table 2 above shows that the variations in the companies Tobin Q were both positive and negative which points out that the companies could only fit in the mixed group meaning that the market valuation of the banks fluctuated over the years and were not consistent in neither direction nor magnitude.

The study further sought to establish the price-to-book value of the listed commercial banks. The price to book value was a function of the ratio of market capitalization to the net asset values of the banks. Price to book value measures the portion of a company that can be claimed by the shareholders if the company is liquidated at that time. The information processed was presented in table 3 below:

**Table 3: Price-to-Book Value of Commercial Banks**

Year	Barclays	Diamond Trust Bank	KCB	NBK	NIC	Standard Chartered
2003	5.18	2.06	1.44	1.24	1.46	7.33
2004	3.27	1.94	1.49	1.44	1.56	5.47
2005	30.92	2.42	2.24	1.78	1.51	3.94
2006	7.04	3.53	4.14	3.01	2.77	5.5
2007	6.11	2.81	4.31	1.88	1.3	5.13
2008	7.34	2.45	4.76	1.9	2.4	5.02
<b>Average</b>	9.98	2.54	3.06	1.88	1.83	5.40
<b>Minimum</b>	3.27	1.94	1.44	1.24	1.3	3.94
<b>Maximum</b>	30.92	3.53	4.76	3.01	2.77	7.33

According to the table, the price-to-book values of the banks were above 1 meaning that the market values of the banks' equity were greater than the value of the net of their total recorded assets.

The study further regressed price-to-book values against corporate governance and presented the data in table 2.

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	19.29881	14.04255		1.37431	0.400456
Frequency of Board Meetings	0.743081	0.186248	0.919489	3.989738	0.156343
Board Size	-2.53231	2.865508	-0.54578	-0.88372	0.539247
Board Composition	2.645539	19.81538	0.09976	0.133509	0.915505
Executive Remuneration	4.64E-07	8.57E-07	0.483821	0.540684	0.684451

The regression equation was:

$$\text{Tobin Q} = \beta + \beta \text{ Board Size} + \beta \text{ Board Composition} + \beta \text{ Board Meetings} + \beta \text{ Executive Remuneration}$$

Whereby board size was the number of board members, board composition was the ratio of non-executive directors to the total number of board members; board meeting was the number of board meetings in a year while the executive remuneration was the average amount of salary and allowances given to an individual board member in a year. The study thus determined the regression equation to be:

$$\text{Tobin Q} = 19.3 - 2.53 \text{ Board Size} + 2.64 \text{ Board Composition} + 0.743 \text{ Board Meetings} + 4.64\text{E-}07 \text{ Executive Remuneration}$$

The regression results shows that when value of the corporate governance indicators/measures used in the study (board size, composition, meetings and executive meetings) are zero, then the market value of the banks' assets relative to their book value becomes 19.3. The results also shows that board size negatively affects firms market performance while board composition affects market performance positively the most and a unit increase in executive remuneration has the least positive influence. The model summary presented in table 3, shows that the relationship was strong as the R square value was 0.95. However the model was insignificant for prediction as the f significance was 0.33 meaning that the model might be 33% wrong in its prediction.

**Table 4: Model Summary**

R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson	
.975a	0.949985	0.749923	1.578726	1.270923	
	Sum of Squares	Df	Mean Square	F	Sig.
Regression	47.340	4	11.835	4.748	.330a
Residual	2.492	1	2.492		
Total	49.832	5			

### 4.3 Commercial Banks Corporate Governance Scores

The study sought to establish the corporate governance practices adopted by the commercial banks in Kenya by looking at the frequency of boards meetings, size and composition of the board, number of board committees at the banks and average salary and benefits that the board members earn per year.

**Table 5: Barclays' Corporate Governance Score**

Year	Frequency of Board Meeting	Board size	Non-executive director	Remuneration	No of committees	Average Salary
2003	4	13	10	46,000,000	3	3538462
2004	4	11	8	47,000,000	3	4272727
2005	4	9	6	56,000,000	3	6222222
2006	8	9	6	52,000,000	3	5777778
2007	7	8	5	50,000,000	3	6250000
2008	8	9	6	59,000,000	3	6555556
<b>Average</b>	<b>5.83</b>	<b>9.83</b>	<b>6.83</b>	<b>51666666.67</b>	<b>3</b>	<b>5436124.06</b>

Barclays banks had on average 6 board meetings per year over the 2003 to 2008 period, had an average board size of 10 members of which 7 were non-executive directors, had 3 board committee and paid an annual average monthly remuneration of Ksh 5,436,124

**Table 6: NIC Banks Ltd Corporate Governance Score**

Year	Frequency of Board Meeting	Board size	Non-executive director	Remuneration	No of Committees	Average Salary
2003	4	10	8	35,359,000	4	3535900
2004	4	10	8	42,496,000	4	4249600
2005	4	10	8	52,234,000	5	5223400
2006	5	10	8	41,480,000	5	4148000
2007	7	10	8	52,042,000	5	5204200
2008	5	10	8	71,225,000	5	7122500
<b>average</b>	<b>4.83</b>	<b>10</b>	<b>8</b>	<b>49139333.3</b>	<b>4.66666667</b>	<b>4913933.3</b>

According to table 6 above, NIC Bank Ltd had on average 5 board meetings per year, composed of an average of 10 directors of which 8 were non-executive directors. The bank had on average, 5 board committees and each board member was remunerated Ksh 4,913,933 annually.

**Table 7: NBK Corporate Governance Score**

Year	Frequency of Board Meeting	Board Size	Non-Executive director	Remuneration	No Of Committees	Average Salary
2003	12	8	5	18,294,000	6	2286750
2004	12	8	6	22,934,000	6	2866750
2005	12	10	7	29,622,000	5	2962200
2006	13	10	7	44,540,000	5	4454000
2007	13	10	7	44,540,000	5	4454000
2008	22	10	7	49,797,000	5	4979700
<b>Average</b>	<b>14</b>	<b>9.3</b>	<b>6.5</b>	<b>34954500</b>	<b>5.3</b>	<b>3667233.3</b>



According to table 7, national Bank of Kenya had an average of 14 board meetings, an average of 9 member corporate governance board of which 7 were non-executive director. The number of board's committee was 5 on average and each board member was remunerated, annual, salary and benefits amounting to Ksh 3,667233.

**Table 8: Standard Chartered Corporate Governance Score**

	Frequency of Board Meeting	Board Size	Non-executive director	Remuneration	No Of Committees	Average Salary
2003	4	11	5	106207000	1	9655182
2004	4	11	5	124819000	1	11347182
2005	4	10	5	135512000	1	13551200
2006	6	9	5	121331000	3	13481222
2007	7	12	8	124150000	5	10345833
2008	7	12	8	125780000	5	10481667
<b>Average</b>	<b>5.33</b>	<b>10.83</b>	<b>6</b>	<b>122966500</b>	<b>2.67</b>	<b>11477047.64</b>

At standard chartered banks, the board meetings were 5 per year, a board composed of 11 directors of which 6 were non-executive. The number of board committee was 3 and each board member earned a salary and benefits amounting to Ksh 11,477,047.

**Table 9: Diamond Trust Bank Ltd Corporate Governance Score**

	Frequency of Board Meeting	Board Size	Non-executive director	Remuneration	No of Committees	Average Salary
2003	9	12	10	15,618,000	5	1301500
2004	10	12	11	20,743,000	4	1728583
2005	9	12	11	16,548,000	4	1379000
2006	8	9	8	19,253,000	6	2139222
2007	5	9	8	23,380,000	6	2597778
2008	4	9	8	29,690,000	6	3298889
<b>Average</b>	<b>7.5</b>	<b>10.5</b>	<b>9.3</b>	<b>20872000</b>	<b>5.17</b>	<b>2074162.04</b>

Diamond Trust Bank Ltd had a board composed of 11 directors, 9 of whom were non-executive directors and met 8 times annually. The number of annual committee were 5 and the directors individual salary and benefits amounted to Ksh 2,074,162

**Table 10: KCB Corporate Governance Score**

Year	Frequency of Board Meeting	Board Size	Non-Executive Director	Remuneration	No of Committees	Average Salary
2003	12	12	10	58574000	5	4881167
2004	12	11	9	57529000	4	5229909
2005	12	11	9	75082000	5	6825636
2006	16	11	9	92920000	6	8447273
2007	12	11	9	113769000	6	10342636
2008	10	11	9	98227000	7	8929727
<b>Average</b>	<b>12.33</b>	<b>11.17</b>	<b>9.17</b>	<b>82683500</b>	<b>5.5</b>	<b>7442724.75</b>

Table 10 above presents the corporate governance score for KCB Bank Ltd. The bank had a 11 board membership composed of 9 directors and 12 meetings a year. The number of board committee was established at 6 and the directors' individual salary and benefits averaged Ksh. 7,442,724.

#### **4.4 Relationship between Performance and Frequency of Board Meetings**

The study sought to establish the relationship between performance and frequency of board meetings by evaluating the following equation:

$$\text{Log (meetings)}_{it} = \partial + \beta_1 Q_{it} + \beta_2 \text{log (Board size)}_{it}$$

Whereby:

$\partial$  = Constant

$\text{Log (meetings)}_{it}$  = log of number of meetings held in year t

$Q_{it}$  = Tobin's Q of bank i for year t.

$\text{Log (board size)}_{it}$  = log of board size.

R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson	
.456a	0.208052	-0.31991	0.224035	1.636333	
	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.039557	2	0.019779	0.394063	.705a
Residual	0.150575	3	0.050192		
Total	0.190132	5			

**Table 11: Relationship between Performance and Frequency of Board Meetings**

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.2852	1.5340		0.8378	0.4636
Tobin Q	-0.2459	0.2801	-0.4522	-0.8780	0.4446
Board Size	-0.0283	0.1476	-0.0987	-0.1916	0.8603

According to the figure above, the equation was found to be:

$$\text{Log (meetings)}_{it} = 1.2852 - 0.2459Q_{it} - 0.0283 \text{ log (Board size)}_{it}$$

According to table 11, there is a negative relationship between banks' market performance and frequency of board meetings. There is also a negative relationship between board size and board meetings.

**Table 12: Model Summary**

#### 4.5 Board Composition and Bank Performance

The study sought to establish the relationship between bank performance and board composition. Board composition was taken as the ratio between members of the board who

are non-executive directors and those who are executive directors. The study further grouped the banks into three groups based on the board composition; insider dominated (if the ratio of non-executive to executive directors is less than 40%), mixed board (if the ratio is between 40% and 65%) and outsider dominated (if the ratio is more than 65%). The data analyzed is presented in table 13. According to the table, Diamond Trust Bank Ltd had the highest ratio of non-executive to executive directors (89%), followed by KCB (82%), then NIC Bank Ltd (80%). It thus follows that NIC, National Bank of Kenya, Diamond Trust Bank, Barclays and KCB's board were outsider dominated while Standard Chartered Bank Ltd was mixed board.

**Table 13: Board Composition**

Bank	Board Composition	Category
National Bank of Kenya Ltd	0.7	Outsider dominated
NIC Bank Ltd	0.8	Outsider dominated
Standard Chartered Bank Ltd	0.55	Mixed Board
Diamond Trust Bank Ltd	0.89	Outsider dominated
Barclays Bank of Kenya Ltd	0.69	Outsider dominated
Kenya Commercial Bank Ltd	0.82	Outsider dominated

To test the board composition and banks performance, by taking the case of the first two banks that had the highest ratio of non-executive to executive directors in the board (Diamond Trust Bank and KCB) and the last two (Standard Chartered Bank and Barclays Bank Ltd). The study used the following equation:

$$Q_{it} = \beta_1 + \beta_2 \log (\text{outside})_{it-1}$$

Where,

Where  $Q_{it}$  = Tobin's Q of Bank i for year t.

$\log (\text{outside})_{it-1}$  = ratio of outside non-executive directors to the total No. of directors lagged one year.

**Table 14: Board Composition and Bank Performance (Diamond Trust Bank)**

	<b>Unstandardized Coefficients (B)</b>	<b>Std. Error</b>	<b>Standardized Coefficients (Beta)</b>	<b>t</b>	<b>Sig.</b>
(Constant)	3.895	3.183		1.223	0.309
Board Composition	-3.965	3.529	-0.544	1.124	0.343

According to table 14 above, there is a negative relationship between board composition and banks' performance.

**Table 15: Board Composition and Bank Performance (KCB)**

	<b>Unstandardized Coefficients (B)</b>	<b>Std. Error</b>	<b>Standardized Coefficients (Beta)</b>	<b>t</b>	<b>Sig.</b>
(Constant)	15.95558	13.41551		1.189	0.32
Board Composition	-19.0025	16.32038	-0.55789	-1.164	0.328

Table 15 further shows that there is a negative relationship between board composition and performance (Tobin Q) as the coefficient is -19.0025.

**Table 16: Board Composition and Bank Performance (Barclays Bank Ltd)**

	<b>Unstandardized Coefficients (B)</b>	<b>Std. Error</b>	<b>Standardized Coefficients - Beta</b>	<b>t</b>	<b>Sig.</b>
(Constant)	5.074	16.239		0.312	0.775
Board Composition	-5.681	24.067	-0.135	0.236	0.829

Table 16 presents the relationship between Barclay's performance and its board composition. The findings reiterate the earlier findings that showed board composition be negatively relate with performance.

**Table 17: Board Composition and Bank Performance (Standard Chartered Bank Ltd)**

	<b>Unstandardized Coefficients (B)</b>	<b>Std. Error</b>	<b>Standardized Coefficients (Beta)</b>	<b>t</b>	<b>Sig.</b>
(Constant)	0.506	0.330		1.533	0.223
Board Composition	0.080	0.572	0.081	0.140	0.897

However on analysis the relationship between board composition and standard chartered bank performance, the study found that a positive relationship as shown in table 17 above.

#### 4.6 Relationship between CEO Remuneration and Bank Performance

The study sought to establish the relationship between executive remuneration and banks' performance by regressing remuneration against Tobin's Q and annual revenue in the following equation:

$$(CEO\ Rem)_{it} = \beta_1 Q_{it} + \beta_2 (Revenue)_{it}$$

Whereby,

$$(CEO\ Rem)_{it} = \text{Log of executive remuneration (Salary + Bonus)}$$

$$Q_{it-1} = \text{Tobin's Q}$$

$$(Revenue)_{it-1} = \text{log of annual revenue.}$$

	<b>Unstandardized Coefficients (B)</b>	<b>Std. Error</b>	<b>Standardized Coefficients (Beta)</b>	<b>t</b>	<b>Sig.</b>
(Constant)	0.501	1.490		0.336	0.759
Tobin Q	-0.339	0.202	-0.477	-1.674	0.193
Revenue	0.693	0.169	1.170	4.109	0.026

The study established that that while there is a positive relationship between remuneration and revenue/profitability, there is a negative relationship between Tobin's Q and remuneration. The equation thus formed is:

$$\text{Remuneration} = 0.501 - 0.339 Q_{it} + 0.693 (Revenue)$$

## CHAPTER FIVE

### 5.0 DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Introduction

From the analysis and data collected, the following discussions, conclusions and recommendations were made. The responses were based on the objectives of the study. The researcher had intended to determine the relationship between corporate governance structure and the performance of banks listed on the Nairobi Stock Exchange.

#### 5.2 Summary and Conclusion

The commercial banks' performance during the study period (2003 to 2008) the study calculated their Tobin Q ratio using market value of firm calculated as their market capitalization divided by the replacement costs of the firm's assets, that is, asset value of the banks and the data findings presented in the table below. From the findings, the study established that, the Q-ratio of all the companies were below 1. Since the Tobin's q is less than 1, then the market value is less than the recorded value of the assets of the company which suggests that the market may be undervaluing the banks. Among the banks, Barclays banks of Kenya has the highest Q-ratio which stands at 1.1356, followed by standard chartered bank at 0.5825, then diamond trust bank at 0.3186, KCB at 0.3019, NIC Bank Ltd at 0.2303 and lastly National Bank of Kenya at 0.1827. However, only Barclays bank of Kenya had a Q-ratio which was more than 1 in 2005 (3.9087) suggesting that in that year market value was greater than the value of the company's recorded assets.

From the findings, the variations in the Q ratio so as to group the banks into 3 groups: losers, winners and mixed. Losers comprise of banks with negative tobin Q variation over the previous year; winners comprise of banks with positive variations in the performance metric over the previous year while mixed comprise of banks whose direction of Tobin Q variation over the previous year will not be consistent at the end of the year according to their

performance. The variations in the companies Tobin Q were both positive and negative which points out that the companies could only fit in the mixed group meaning that the market valuation of the banks fluctuated over the years and were not consistent in neither direction nor magnitude.

The studies established the price-to-book value of the listed commercial banks. The price to book value was a function of the ratio of market capitalization to the net asset values of the banks. Price to book value measures the portion of a company that can be claimed by the shareholders if the company is liquidated at that time. According to the finding of the study, the price-to-book values of the banks were above 1 meaning that the market values of the banks' equity were greater than the value of the net of their total recorded assets.

The regressed price-to-book values against corporate governance yielded the following regression equation:

$$\text{Tobin Q} = \beta + \beta \text{ Board Size} + \beta \text{ Board Composition} + \beta \text{ Board Meetings} + \beta \text{ Executive Remuneration}$$

Whereby board size was the number of board members, board composition was the ratio of non-executive directors to the total number of board members; board meeting was the number of board meetings in a year while the executive remuneration was the average amount of salary and allowances given to an individual board member in a year. The study thus determined the regression equation to be:

$$\text{Tobin Q} = 19.3 - 2.53 \text{ Board Size} + 2.64 \text{ Board Composition} + 0.743 \text{ Board Meetings} + 4.64\text{E-}07 \text{ Executive Remuneration}$$

The regression results shows that when value of the corporate governance indicators/measures used in the study (board size, composition, meetings and executive meetings) are zero, then the market value of the banks' assets relative to their book value becomes 19.3. The results also shows that board size negatively affects firms market performance while board composition affects market performance positively the most and a



unit increase in executive remuneration has the least positive influence. The model summary presented in table 3, shows that the relationship was strong as the R square value was 0.95. However the model was insignificant for prediction as the f significance was 0.33 meaning that the model might be 33% wrong in its prediction.

The study established the corporate governance practices adopted by the commercial banks in Kenya by looking at the frequency of boards meetings, size and composition of the board, number of board committees at the banks and average salary and benefits that the board members earn per year. Barclay's banks had on average 6 board meetings per year over the 2003 to 2008 period, had an average board size of 10 members of which 7 were non-executive directors, had 3 board committee and paid an annual average monthly remuneration of Ksh 5,436,124. The NIC Bank Ltd had on average 5 board meetings per year, composed of an average of 10 directors of which 8 were non-executive directors. The bank had on average, 5 board committees and each board member was remunerated Ksh 4,913,933 annually. National Bank of Kenya had an average of 14 board meetings, an average of 9 member corporate governance board of which 7 were non-executive director. The number of board's committee was 5 on average and each board member was remunerated, annual, salary and benefits amounting to Ksh 3,667,233. At standard chartered banks, the board meetings were 5 per year, a board composed of 11 directors of which 6 were non-executive. The number of board committee was 3 and each board member earned a salary and benefits amounting to Ksh 11,477,047. Diamond Trust Bank Ltd had a board composed of 11 directors, 9 of whom were non-executive directors and met 8 times annually. The number of annual committee were 5 and the directors individual salary and benefits amounted to Ksh 2,074,162

From the above discussion the study found that Q-ratio of all the companies were below 1. Since the Tobin's q is less than 1, then the market value is less than the recorded value of the assets of the company which suggests that the market may be undervaluing the banks. Among the banks, this suggests that in that year market value was greater than the value of

the company's recorded assets, the study thus concludes that there is a positive relationship between corporate governance structure and bank performances of the preceding year.

The study found that there was a variation on Tobin Q over the previous year and they were not consistent at the end of the year according to their performance. The variations in the companies Tobin Q were both positive and negative, thus the companies could only fit in the mixed group meaning that the market valuation of the banks fluctuated over the years and were not consistent in neither direction nor magnitude

The price-to-book value of the listed commercial banks, the price to book value is a function of the ratio of market capitalization to the net asset values of the banks. Price to book value measures the portion of a company that can be claimed by the shareholders if the company is liquidated at that time, the price-to-book values of the banks were above 1 meaning that the market values of the banks' equity were greater than the value of the net of their total recorded assets. The regressed price-to-book values against corporate governance yielded the following regression equation were: **Tobin Q = 19.3 -2.53 Board Size + 2.64 Board Composition + 0.743 Board Meetings + 4.64E-07 Executive Remuneration.**

This study also concludes that board size negatively affects firm's market performance while board composition affects market performance positively the most and a unit increase in executive remuneration has the least positive influence. The study concludes that corporate governance practices adopted by the commercial banks in Kenya by looking at the frequency of boards meetings, size and composition of the board, number of board committees at the banks and average salary and benefits that the board members earn per year has effect on the market performance of the banks.

From the above discussion, conclusion of the study recommends that for banks to have better market performances should adopt better corporate governance practices since corporate governance practices affects the market performance of the banks positively. The study also recommends that board size of the banks should be small and there should be less executive remuneration as this affects banks performance negatively

### **5.3 Limitations of the Study**

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information. The main limitations of this study were: The researcher was faced with a challenge of accessing information required from the banks for the completion of the study. The small size of the sample could have limited confidence in the results and this might limit generalizations to other situations or generalization of the status in all the banks. Time- Due to official duties time was a major concern.

### **5.4 Suggestion for Further Research**

The study suggests that further studies should be done on other institutions listed in the NSE such as insurance companies so as to establish the relationship between their corporate governance structures and their performance.

Further, a similar study should be done on the effect of the governance structures on the performance of all the banks in Kenya so as to establish the overall effect and allow for generalization on the effect of the structures on the bank performance.

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## LISTED COMMERCIAL BANKS

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2. \*\*\*CFC Stanbic Holdings Ltd - merger
3. Diamond Trust Bank Kenya Ltd (DTB)
4. \*\*\*Equity Bank Ltd – listed in 2006
5. Kenya Commercial Bank Ltd (KCB)
6. National Bank of Kenya Ltd (NBK)
7. NIC Bank Ltd
8. Standard Chartered Bank Ltd (StanChart)
9. \*\*\*Co-operative Bank of Kenya Ltd – listed in 2008