CORPORATE GOVERNANCE AND FIRM PERFORMANCE OF FINANCIAL INSTITUTIONS LISTED IN NAIROBI STOCK EXCHANGE

BY

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A management research project report submitted in partial fulfillment of the requirements for the award of Master of Business Administration, School of Business, and University of Nairobi.

DECLARATION

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

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This research project report has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

This project is dedicated to my wife Ruth, our daughter Angela, my parents and all my siblings for their support, sacrifices, patience and encouragements throughout my academic endeavors.

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My sincere gratitude goes to my supervisor Mr. James Ng'ang'a for his guidance, invaluable assistance and contributions that led to the successful pursuit of this project to its conclusion. I am so much grateful for his reliability that enabled me to consult with him severally to enhance the quality of this project.

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To my employer I say thank you for allowing me to proceed for study leave during the examination periods.

ABSTRACT

Financial Institutions in the Nairobi exchange have different mechanisms through which boards and directors are able to direct, monitor and supervise the conduct and operation of corporations and their management in a manner that ensures appropriate levels of authority, accountability, stewardship, leadership, direction and control different governance structures. The question is, is there any relationship between corporate governance and firm performance.

This study examines whether the performance of Financial Institutions listed in Nairobi Stock Exchange is affected by the corporate governance practices put in place. The analysis is done by constructing a Governance Index as per Globe & Mail rankings using Data from the Financial Institutions and performance measure from annual reports.

The empirical findings of this study are consistent with the guidance developed by capital Market Authority and Central Bank of Kenya that companies should endeavor to attain the highest possible level of corporate governance.

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CHAPTER ONE

INTRODUCTION

1.1 Background of Study

One of the emerging issues in corporate finance is corporate governance. Corporate governance is the manner in which power is exercised in the management of economic and social resources for sustainable human development, it has assumed critical importance in these days of political pluralism. It is a vital ingredient in the maintenance of a dynamic balance between the need for order and equality in society, the efficient production and delivery of goods and services, accountability in the use of power, the protection of human rights and freedoms, and the maintenance of an organized corporate framework within which each citizen can contribute fully towards finding innovative solutions to common problems(Private Sector Initiative for Corporate Governance Principles for Corporate Governance in Kenya 2001)

Corporate governance is a field in economics that investigates 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 that the corporate managers will deliver a competitive rate of return (Mathiesen, 2002)

In relation to governance of financial institutions, agency theory has both merits and shortcomings. It provides good explanations in many situations but it has severe difficulties in dealing with institutions with several stakeholders and complex objective functions for the management. Firms guided by shareholder value may work more effectively than firms guided by stakeholder disharmony. Depositors are important stakeholders in banks. Since they are typically incapable of managing the supervision of their claims on the bank, they rely on regulators to do it for them. Remuneration systems for bank managers should provide proper incentives (Gordon and John 1992).

Corporate Governance is a mechanism through which boards and directors are able to direct, monitor and supervise the conduct and operation of the corporation and its management in a manner that ensures appropriate levels of authority, accountability, stewardship, leadership, direction and control. Corporate governance codes do not often explicitly define what corporate governance is. Most codes of best practice deal with corporate governance as a concept and explain its importance without defining its meaning. Yet the way corporate governance is defined may affect the scope and content of a code. Perhaps the most famous definition of corporate governance was provided in 1992 by Sir Adrian Cadbury in the Report on Financial Aspects of Corporate Governance in the United Kingdom which states that Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goal. The aim is to align as nearly as possible the interests of individuals, corporations and society (Sir Adrian Cadbury Corporate Governance Overview, 1992)

Corporate governance is the system by which companies are directed and controlled. Corporate governance can therefore be considered as a set of mechanisms through which firms operate when ownership is separated from management. But whether a broad or a narrow definition of corporate governance is chosen, it is important that the fundamental values of transparency, accountability, fairness, and responsibility be respected in order for firms to build and sustain the confidence of investors, stakeholders, and society as a whole. The importance of corporate governance lies in its contribution both to business prosperity and to accountability (Hampel Committee, 1998).

The term ‘corporate governance’ is susceptible both to broad and narrow definitions. In fact, many of the codes do not even attempt to articulate what is encompassed by the term. The important point is that corporate governance is a concept, rather than an individual instrument. It includes debate on the appropriate management and control structures of a company. Further it includes the rules relating to the power relations between owners, the Board of Directors, management and, last but not least, the stakeholders such as employees, suppliers, customers and the public at large (Murthy, 2003).

The question of the firm performance is very important for different groups of people. All agents that have to make any financial decisions about a company are concerned with its financial position. Thus, owners, managers, potential investors, banks, other financial institutions, creditors, business partners, employees, and government are interested in models that help to analyse and predict the performance of the companies (Jonathan 1994).

Management researchers prefer accounting variables as performance measures such as return on equity (ROE), return on investment (ROI), and return on assets (ROA), along with their variability as measures of risk. Earlier studies typically measure accounting rates of return. These include: (ROI), return on capital (ROC), return on assets (ROA) and return on sales (ROS) (Hendrik and Elaine 2009).

The idea behind these measures is perhaps to evaluate managerial performance-how well is a firm's management using the assets to generate accounting returns per amount of investment, assets or sales. The problems with these measures are well known. Accounting returns include depreciation and inventory costs and affect the accurate reporting of earnings. Asset values are also recorded historically. Since accounting conventions make these variables unreliable, financial economists prefer market returns or discounted cash flows as measures of performance. For the sake of consistency, two accounting measures ROE and ROA can be used along with market return to measure performance (Spong & Richard 2007).

Return on equity (ROE) is a frequently used variable in judging top management performance, and for making executive compensation decisions. ROE can be used as a measure to judge performance and calculate the average return on equity (AROE) across all sampled firms and time periods, its standard deviation and also the coefficient of variation for each of the three diversification groups. ROE is defined as net income (income available to common stockholders) divided by stockholders equity. The coefficient of variation (CV) gives us the risk per unit of average return (Jonathan 1994).

ROA is the most frequently used performance measure in previous studies. It is defined as net income (income available to common stockholders), divided by the book value of total assets. We also calculate the average return on assets (AROA) across all sampled firms and time periods calculate its standard deviation and also the coefficient of variation for each of the three diversification groups (Hendrik and Elaine. 2009).

Market return (MKTRET), is another measure of performance. MKTRET is computed for a calendar year by taking the difference between the current year's ending stock price, and the previous year's ending price, adding to it the dividends paid out for the year, and then dividing the result by the previous year's ending price (Brown and Marcus 2004).

The Nairobi Stock Exchange (NSE) has played an important role in mobilizing resources and providing a means by which companies can raise capital. By providing companied with an opportunity to be privatized, the NSE has ensured that ownership of such companies in widely distributed among members of the public. The NSE promoted the inflow of foreign capital from 1995 when the government permitted foreign investors to invest in the ownership of local quoted companies (Jebet 2001).

The Financial Service sector is perhaps the most significance economic sector in modern Society. In the more advance service economies like the United States, financial sector employs more people than manufacturing of apparel, automobiles, computers, pharmaceuticals and steel combined (Harker 2000). It is therefore justified that performance of Financial Institutions receives extensive scrutiny from Scholars and industry thinkers. While the performance of Financial Institutions have been studied and debated at length, much less have been done to understanding the performance of institutions that operate in these markets (Merton 1990).This necessitates the understanding of Corporate Governance in Financial Institutions and where it contributes in their performance.

1.2 Statement of the Problem

The separation of ownership and control in publicly held corporations induces conflicts of interest between managers and shareholders (Berle and Means, 1932). Shareholders are interested in maximizing the value of the firm, but managers' objectives may also include the increase of perquisite consumption and job security. A number of governance mechanisms may help to align the interests of managers with those of shareholders. This includes equity ownership by managers (Jensen and Meckling, 1976), by outside blockholders (Kaplan and Minton, 1994) and executive compensation (Mehran, 1995). In addition the board of directors may play a central role in monitoring managers (Fama, 1980). Board size, board composition and the leadership structure of the board are important characteristics that affect the effectiveness of the board in monitoring management (Jensen, 1993).

The role of ownership structure (Morck et al., 1988 , and McConnell and Servaes, 1990) and board structure (Baysinger and Butler, 1985 ; Rechner and Dalton, 1991 ; Yermack, 1996, Eisenberg et al., 1998, and Bhagat and Black, 2002) in monitoring management and so improving firm performance has been largely investigated in empirical corporate governance literature. The results are mixed the approach used in studying the relation between governance mechanisms and firm performance is mostly the same.

The classical argument about the relationship between corporate governance variables and firm performance is that, for some variables, the greater the level of the variable and the better is firm performance; the opposite holds for other variables. The rationale behind this is that the effectiveness of larger boards is lower, and firms will gain, in terms of performance, if they choose to operate with boards composed of a limited number of directors. However, another argument consists to say that each corporate control mechanism generates benefits to the firm but also entails costs. Therefore, a corporate control mechanism will be used up to a level where the marginal benefits equal the marginal costs. Most importantly, the optimal levels of the different control mechanisms may vary across firms, yielding different levels of use of each mechanism but with equally good performance Mohamed (2006).

In addition to the optimal use of each corporate control mechanism, a number of these mechanisms are designed to achieve the same objective, which is to reduce the extent of the moral hazard behavior by managers. Consequently, higher levels of the use of one mechanism may induce lower levels of the use of other mechanisms, without having a negative effect on firm performance. According to this argument, a cross sectional analysis would not yield any significant relationship between corporate governance mechanisms and firm performance, all other things being equal Mohamed (2006).

Because of the inconsistencies in the previous studies, this study will seek to find out what are the corporate governance structures prevalent specifically in Financial Institutions listed in Kenya and whether performance is better in those institutions whose corporate governance structures are considered to be better.

In Kenya studies have been done in corporate governance; Makobe (2004) and Jebet 2002 conducted a research on corporate governance. Makobe studied companies listed in the NSE and found out that corporate governance is still a major issue. Study done by Mwangi (2002) specifically focused on Insurance companies in his study with Wangombe focusing on Corporate Societies and study done by Mutisya (2006) corporate governance and firm performance listed in the NSE which was general to all listed companies. No study has been done to give specific emphasis to financial institutions. This study will attempt to do so by identifying such aspects of corporate governance as Board composition, Shareholding and compensation, Shareholders rights and Board Governance Disclosure issues in financial institutions and relating them to performance.

1.3 Objective of the Study

The study intends to establish relationship between selected aspects of corporate governance and performance of financial institutions.

1.4 Importance of the Study

Policy Maker: The study can be used by the NSE and CMA to encourage compliance to the existing guidelines by establishing if there is a relationship between corporate governance and firm performance.

Shareholders: The investors can use this study to construct corporate governance index and use to this index to forecast future performance of companies listed in Nairobi Stock Exchange and this information could be used by investors to contract portfolio.

Academics and Scholars: The study will provide a basis for further studies into the area of corporate governance.

CHAPTER TWO:
LITERATURE REVIEW

2.1 Introduction

This chapter examines empirical studies that have been done in the area of corporate governance.

2.1.1 History of Corporate Governance

In the 20th century in the immediate aftermath of the Wall Street Crash of 1929 legal scholars such as Adolf Augustus Berle, Edwin Dodd, and Gardiner C. Means pondered on the changing role of the modern corporation in society. Berle and Means' monograph "The Modern Corporation and Private Property" (1932, Macmillan) continues to have a profound influence on the conception of corporate governance in scholarly debates today. From the Chicago school of economics, Ronald Coase's "Nature of the Firm" (1937) introduced the notion of transaction costs into the understanding of why firms are founded and how they continue to behave. Fifty years later, Eugene Fama and Michael Jensen's "The Separation of Ownership and Control" (1983, Journal of Law and Economics) firmly established agency theory as a way of understanding corporate governance: the firm is seen as a series of contracts. Agency theory's dominance was highlighted in a 1989 article by Kathleen Eisenhardt (Academy of Management Review). US expansion after World War II through the emergence of multinational corporations saw the establishment of the managerial class. Accordingly, the following Harvard Business School management professors published influential monographs studying their prominence: Myles Mace (entrepreneurship), Alfred D. Chandler, Jr. (business history), Jay Lorsch (organizational behavior) and Elizabeth MacIver (organizational behavior).

According to Lorsch and MacIver "many large corporations have dominant control over business affairs without sufficient accountability or monitoring by their board of directors." Current preoccupation with corporate governance can be pinpointed at two events: The East Asian Crisis of 1997 saw the economies of Thailand, Indonesia, South Korea, Malaysia and The Philippines severely affected by the exit of foreign capital after property assets collapsed. The lack of corporate governance mechanisms

in these countries highlighted the weaknesses of the institutions in their economies. The second event was the US corporate crises of which saw the collapse of two big corporations: Enron and WorldCom, and the ensuing scandals and collapses in other organizations such as Arthur Andersen, Global Crossing and Tyco Chatzkel, (2003).

In Corporate Governance Issues in Non-Shareholder Value Financial Institutions: A Case Study of Mutual Building Societies in the UK, (Llewellyn 2003), focuses on corporate governance in non-incorporated financial firms. The author describes the relevant stakeholders and the nature of agency problems in different types of financial firms. He compares monitoring mechanisms, incentives, abilities and feasibilities of managers and members of mutuals. Mutuality raises specific corporate governance issues: Corporate governance is less clearly defined because the firm's objectives are less clearly defined. Conflicts of interest between managers and owners are less easily identified and it is more difficult to create management incentives. The almost exclusive source of capital is retained profits and each member has a non-exclusive and non-marketable claim to residual net worth. Voting rights are typically not proportional to the size of the ownership stake. There is no market in ownership claims and therefore no effective market in corporate control. Consequently, there is ample scope for mutuals to be inefficient. There is, however, no evidence that the efficiency and performance of mutuals are poorer that that of incorporated financial firms (Spyros et al 2007).

2.2 Theoretical Frame Work

Does a company's corporate governance structure influence its financial performance? The results of many event studies indicate that, on average, a firm's stock price decreases when its corporate governance structure becomes more restrictive. Examples include the adoption of certain charter amendments (Jarrell and Poulsen 1987, Bhagat and Jefbries 1991), poison pills (Malatesta and Walkling 1988, Ryngaert 1988, Bruner 1991), and state takeover laws off and Malatesta 1989). A common conclusion of these studies is that a restrictive governance structure decreases managers' accountability to shareholders, which is expected to harm the firm's long-term financial performance. There is little direct evidence, however, on the actual performance effects of corporate governance provisions

The finance literature argues that firms in general face two types of governance problems: the governance problem between managers and shareholders, and the governance problem between majority and minority shareholders (Shleifer and Vishny 1997). Following Roe (2004), these problems vertical and horizontal governance problems, respectively. While both governance problems exist in private firms, legal scholars and practitioners argue that the main governance problem in close corporations is the horizontal one, in particular the squeeze-out of minority shareholders by the controlling shareholder (Clark 1986; O'Neal and Thompson 1985). As a solution, both the legal (O'Neal and Thompson, 1985, chapter 9) and the finance literature (Bennedsen and Wolfenzon 2000; Gomes and Novaes 2000; Pagano and Roell 1998) recommend that the main shareholder surrender some control to minority shareholders at the outset. With shared control rights, no shareholder can take unilateral actions for her own benefit at the expense of the firm and other shareholders.

Both the legal and the finance literature (e.g., O'Neal and Thompson 1985; Bennedsen and Wolfenzon 2000) suggest a simple way to achieve shared control: shared ownership. Yet, little empirical evidence exists on the horizontal governance problem in close corporations and the effectiveness of the shared ownership solution.

2.2.1 Agency theory of Corporate Governance

Agency theory is concerned with aligning the interests of owners and managers (Jensen and Meckling, 1976; Fama and Jensen, 1983) and is based on the premise that there is an inherent conflict between the interests of a firm's owners and its management (Fama and Jensen, 1983). The recognition of this conflict is documented as far back as Adam Smith (1776), but its salience was not realized until the expansion of capitalism in the late 1800s and early 1900s led to a widespread separation of the ownership and control functions of the firm. This meant that managers now possessed superior knowledge and expertise to the firm's owners and were therefore in a position to pursue self-interested action at the expense of shareholders. Jensen and Meckling (1976), who argued that agency costs are an inevitable part of the management/ownership relationship, formalized this hypothesis into a mathematical model.

The impact of agency theory on corporate governance research can be observed in the predominance of studies that examine two key questions, namely, how the composition of boards of directors affects firm performance and how the leadership structure of the company (i.e. the duality of the CEO/chairman role) affects corporate performance. Findings from these studies have been contradictory. Studies of outsider ratios and firm performance, for example, have produced findings ranging from positive correlations, to negative to no significant correlation at all. In summary, extensive research in the area has shown any relationship between composition and/or leadership structure and firm performance to be inconsistent and conflicting.

As to the mechanism by which a board is expected to impact on corporate performance, agency theory suggests that a greater proportion of outside/independent directors will be able to monitor any self-interested actions by managers. As a result of the monitoring, there will be less opportunity for managers to pursue self-interest at the expense of owners (lower agency costs) and so shareholders will enjoy greater returns (or increased profits). The agency model is widely accepted in the business community, as can be seen by the widespread adoption of normative guidelines emphasizing the need for independent directors to monitor the activities of the board If agency theory holds, therefore, one would expect to find the following patterns:

High levels of outsiders on the board are associated with high monitoring of management, which is associated with low agency costs and consequently high corporate performance.

Low levels of outsiders on the board are associated with low monitoring of management, which is associated with high agency costs and low corporate performance. Nicholson & Kiel (2007).

Alternatively, agency theory suggests that if management interests dominate the board, there will be little opportunity for monitoring of their activities. As a result, we would expect there to be a link between the reduced monitoring and a rise in agency costs. These agency costs (both direct perquisites and indirect agency costs such as unprofitable growth) would result in reduced corporate profits.

2.2.2 Stewardship theory

This theory focuses on the proportion of insiders on the board to investigate links with corporate performance. From this perspective, one expects to see significantly different patterns emerge. More particularly, it is expected to see that a high proportion of inside directors would lead to greater access to information, superior decision-making and therefore higher firm performance.

Nicholson & Kiel (2007) examined seven cases out of which only two conformed to the expected patterns i.e.(high insider-proportion and high access to information). The insider-dominated board did follow a segment of the pattern, but this did not translate into quality decision-making and improved corporate performance. In point of fact, this organization was the worst performing of the seven cases.

Two of the cases supported the pattern predicted by stewardship theory, it is difficult, given the information uncovered in the case research, to support the claim that high access to information, quality decision-making and subsequent strong performance would have occurred had there been a greater number of insiders on the board. These (cases) organizations, while high on outside directors were moderate to low on independent directors. In both cases several of the outside directors had long and in-depth experience with the organizations, approaching the level of understanding expected of inside directors.

However, this knowledge base and a high level of involvement were not sufficient to provide either access to information or quality of decision-making to improve performance in the short term.

2.2.3 Resource Dependent Theory

This proposes that the board plays a crucial role in linking the organization to necessary resources. Thus, it is expected that boards that have significant links to fundamentally important constituencies and/or resources will contribute significantly to firm performance Nicholson & Kiel (2007), examined seven cases, in each, the test of the resource dependence patterns revealed no consistency across the cases. There was no match in five cases, while the only match to a pattern was provided by one case where directors had few external linkages, provided very little resources to the company, and the organization was under considerable financial strain

Another case provided a partial match to pattern one which associated low links with the environment and low access to resources with poor performance. Five of the directors were farmers who had strong links with other farmer suppliers. However, they have few links with either the general environment or key customers. Fieldwork established that much of the attention of the organization had been focused on farmer supplier issues, to the detriment of more general business issues, which in turn was one cause of the organization's low performance. This could be argued to be a situation where some links to the environment had led to a misdirection of governance and corporate effort, while a lack of other links had led to the outcomes predicted by resource dependence theory.

2.3 Empirical Studies of Corporate governance

In its 'Global Investor Opinion Survey' of over 200 institutional investors first undertaken in 2000 and updated in 2002, McKinsey found that 80% of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly out-side directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests for information on governance issues. Other studies have linked broad perceptions of the quality of companies to superior share price performance.

In a study of five year cumulative returns of Fortune Magazine's survey of 'most admired firms', it was found that those "most admired" had an average return of 125%, whilst the 'least admired' firms returned 80%. In a separate study Business Week enlisted institutional investors and 'experts' to assist in differentiating between boards with good and bad

governance and found that companies with the highest rankings had the highest financial returns.

On the other hand, research into the relationship between specific corporate governance controls and firm performance has been mixed and often weak. The following examples are illustrative.

Studies conducted by Chhaochharia & Grinstein (2007) revealed among others that the announcement of the Sarbanes–Oxley Act in the USA in 2002 had a significant effect on firm value. Firms that are less compliant with the provisions of the rules earned positive abnormal returns compared to firms that are more compliant. We also find variation in the response across firm size. Large firms that are less compliant earned positive abnormal returns but small firms that are less compliant earned negative abnormal returns, suggesting that some provisions are detrimental to small firms.

Many of these studies find that certain governance structures are associated with better performance and higher firm value. However, it is sometimes hard to interpret the results in these studies since governance structure is a variable chosen by firms, in part because of their monitoring needs. Controlling for this endogenous relation often requires additional assumptions on the potential effect of firm characteristics on governance structure and firm value, which can lead to estimation bias and reduced statistical power. The new governance rules in the US offer a unique laboratory to test the effect of governance structure on firm value since the rules can be considered an outside intervention to the governance structure of firms (Chhaochharia & Grinstein, 2007).

Some researchers have found support for the relationship between frequency of board meetings and profitability. Others have found a negative relationship between the proportion of external directors and firm performance, while others found no relationship between external board membership and performance.

Bhagat &Black (1999) found that companies with more independent boards do not perform better than other companies. It is unlikely that board composition has a direct impact on firm performance.

The results of previous research on the relationship between firm performance and executive compensation have failed to find consistent and significant relationships between executives' remuneration and firm performance.

Some researchers have found that the largest CEO performance incentives came from ownership of the firm's shares, while other researchers found that the relationship between share ownership and firm performance was dependent on the level of ownership.

The results suggest that increases in ownership above 20% cause management to become more entrenched, and less interested in the welfare of their shareholders.
Drobetz, Schillhofer, and Zimmermann (2003) construct a broad corporate governance index, based on 30 governance proxies divided into five distinct categories (e.g., corporate governance commitment, shareholder rights, transparency, management and supervisory board matters, and auditing) from data obtained from survey and other archival sources, for German public firms. The study presents mixed evidence on whether there is any relationship between good governance and firm performance.

2.4 Summary and Conclusion

The above studies have established that increasingly companies are facing a challenge of separation of ownership and control. Shareholders elect Board of directors who delegate the day to day running of a company to management. However the ability of shareholders to elect and control directors is influenced by extent of shareholding.
Generally studies have shown that the relations between corporate governance provisions and firm performance certainly reflect noisy data. ROA, for example, is affected by firm-specific accounting choices. In addition, any industry-adjustment procedure is most likely an imperfect way to deal with the fact that governance structure and firm performance are both determined endogenously within the competitive process.

Firms with an unusually low number of restrictive governance provisions compared with other firms in their industries studies have shown they have the highest mean industry-adjusted ROAs and MBV.

These studies were however not conclusive on how Board composition, Shareholding, Compensation, Shareholding rights and Board governance disclosure influence performance. The inconsistency may have been due to the fact that the studies tried to use statistical analysis to establish a relationship. Statistical analysis mostly capture

quantitative factors that influence company performance however the company may differ in that the members of board of director have different skills , experience and knowledge and hence influence the quality of their performance. These two companies may have different performance irrespective of similar corporate structure.

In Kenya studies have been done in corporate governance; Makobe (2004) and Jebet 2002 conducted a research on corporate governance. Makobe studied companies listed in the NSE and found out that corporate governance is still a major issue. Study done by Mwangi (2002) specifically focused on Insurance companies in his study with Wangombe focusing on Corporate Societies and study done by Mutisya (2006) corporate governance and firm performance listed in the NSE which was general to all listed companies. No study has been done to give specific emphasis to financial institutions.

CHAPTER THREE:
RESEARCH METHODOLOGY

3.1 Introduction

This chapter explains the population of interest, type of secondary data used, source of data and technique used in data analysis.

In this paper the relationship between corporate governance and firm performance was investigated. Corporate governance measures was considered in terms of board composition, shareholding composition and compensation while firm performance was measured in terms of ROA (Return to Asset)

3.2 Research Design

This study involved a survey of corporate governance in Financial Institutions. Corporate governance in measured by Board composition, Shareholding and compensation, Shareholder Rights and Board governance. The corporate governance measures were obtained from Primary data through questionnaires

3.3 Population

The target population in this study was all the 15 financial institutions listed in The Nairobi Stock as at 31st December 2009. (As per Appendix D)

3.4 Sampling

A sample means a subject of the whole population, which is selected and analyzed, and the results obtained are generalized to represent the whole population. In the research, the researcher generates a sample from the NSE. Since there are only 15 listed Financial Institutions in The NSE as at December 2009, all companies which were actively trading between 2005 and 2009 were be studied.

The period of study 2005-2009 is considered reasonable because this is the period when corporate governance has taken root in Kenya and also due to availability of data.

3.5 Data Collection

The study is based on Secondary data and structured questionnaires. Corporate governance scoring was done based on Globe and Mail rankings. The questionnaire is divided into four (4) sections that comprise the composite scores and ranking to measure: Board composition, Board Shareholding and Compensation, Shareholder Rights, Board Governance Disclosure. The respondents comprised mainly Public relation managers in the financial institutions to be studies. The data was then be checked for completeness and consistency .The questionnaires were then be validated for accuracy and reliability by comparing the responses with available information for situation where the information can be found by other means e.g. number of women directors from NSE or company publication. The maximum composite score that a company can achieve is 100 points.

3.6 Measure of Performance

Firm performance is an independent variable and composite governance scores are the dependant variables in the overall research design. Firm performance was be measured by return on assets.

3.6.1 Rationale for Using ROA

ROA measures return earned by a company on its assets. The higher the ratio the more income is raised by a given level of assets.Return on assets is an indicator of how profitable a company is before leverage, and is compared with companies in the same industry. Return on assets is a common figure used for comparing performance of financial institutions (such as banks), because the majority of their assets will have a carrying value that is close to their actual market value

3.7 Data Analysis techniques

Multiple regression analysis was used to investigate the relationship between corporate governance and Performance of the firm in financial institutions by use of SPSS.

Return on Asset (ROA) percentage shows how profitable a company's assets are in generating revenue.

ROA can be computed as:

$$ROA = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

It indicates what the company can do with what it has, i.e. earnings they derive from each assets they control. It's a useful number for comparing competing companies in the same industry. The number will vary widely across different industries. Return on assets gives an indication of the capital intensity of the company, which will depend on the industry; companies that require large initial investments will generally have lower return on assets.

Corporate governance

Measured by Board composition, Shareholding and Compensation, Shareholder Rights, Board Governance Disclosure issues as constructed by the corporate governance index in Appendix A.

$ROA_{it} = K + aBcomp_{it} + bShCompe_{it} + cShRt_{it} + dBogDisc_{it}$

Where ROA_{it} is Return on Asset of asset i at time t defined by Net Income/Average Total Asset

$Bcomp_{it}$- is Board composition of company i at time t.

$ShCompe_{it}$ is Share holding and Compensation of company i at time t.

$ShRt_{it}$- Shareholder Rights of company i at time t.

$BogDisc_{it}$- Board Governance Disclosure of Company i at time t

k, a, b, c, and d are constant terms

CHAPTER FOUR
DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter covers data analysis, interpretation and discussion of the research findings. The data is analyzed and presented in the form of tables, proportions, tables as well as charts. The data obtained were scored under the four elements of corporate governance i.e. Board composition, Shareholding and Compensation, Shareholder Rights, Board Governance Disclosure

4.2 Corporate Governance Measures in Listed Financial Institutions

The weight of each of the components was based on the relative importance of each component as expounded in the research methodology. Scoring of the quality of Corporate Governance can be subjective and controversial. Analysts are unlikely to agree whether or not certain elements should be included, how much weight should be given to each element and what score should be given to respective questions.

However because this survey covered a large number of questions taking into consideration various aspects of corporate governance, this mitigated the problem of subjectivity in scoring. Corporate governance practices were scored out of 100% as shown in Table 1.The extent of corporate governance for each institution was interpreted in terms of its percentage (%) score.

Table 4.1 Corporate governance measure

Financial Institution	Board composition Out of 41%	Share holding and Compensation Out of 20%	Shareholder Rights Out of 24%	Board Governance Disclosure issues Out of 15%	Total Out of 100%
Barclays Bank	33	17	20	11	81
Centum	35	18	22	12	87
CFC Stanbic Bank	25	14	13	8	60
Co-op Bank	31	16	19	10	76
Diamond Trust Bank	29	15	17	9	70
Equity Bank	35	19	21	11	86
HFCK Bank	28	15	16	9	68
Jubilee Insurance	22	12	13	9	56
KCB Bank	32	18	19	11	80
Kenya Reinsurance	36	18	23	11	88
NBK Bank	30	15	18	10	73
NIC Bank	28	14	17	9	68
Olympia Capital	26	13	13	8	60
PanAfrican Insurance	29	14	18	9	70
Standachart Bank	33	18	20	11	82

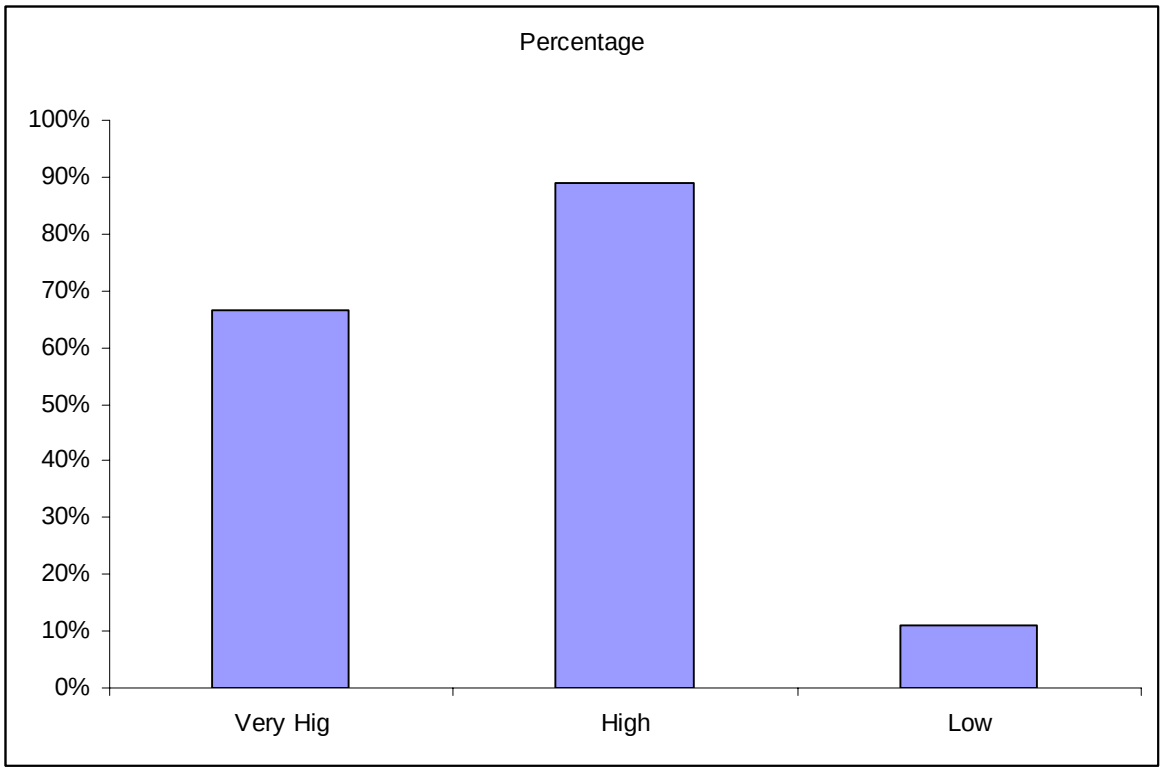
Research Findings

Except Jubilee Insurance, all the other Financial Institutions have high or very high scores. This can be attributed to the fact that Financial Institutions are subjected to regulatory bodies such as Capital Market Authority (CMA), Central Bank of Kenya (CBK), Commission of Insurance and Nairobi Stock Exchange (NSE) to adopt high standards hence the high corporate governance standards.

Corporate governance score was grouped into levels with a score of 80% and above as very high, 60% to 79% high, 50% to 59% as low and below 50% as very low.

The low score in Jubilee insurance could be explained by the ownership structure and management control on how the institution is managed. Most proportion of the company is owned by very few people who have high control of management and running of the company. The small individual investors are therefore not able to exercise their shareholder rights as they would wish.

Figure 4.1 Level of Corporate governance



Research Findings

4.3 Firm Performance in Listed Financial Institutions

Performance was measured on the basis of Return on Assets (RAO)

$$ROA = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

Table 4.2 Performance in Financial Institutions

Financial Institution	2005	2006	2007	2008	2009	Average ROA
Barclays Bank of Kenya	3.0%	4.0%	3.1%	3.3%	3.7%	3.4%
Centum Investment	4.6%	4.4%	4.5%	4.7%	4.5%	4.5%
CFC Stanbic Bank	1.7%	2.3%	2.1%	2.3%	2.1%	2.1%
Co-op Bank	1.4%	2.2%	3.5%	4.0%	3.5%	2.9%
Diamond Trust Bank	2.1%	2.6%	2.4%	2.2%	2.0%	2.3%
Equity Bank	4.4%	5.2%	4.5%	5.3%	5.2%	4.9%
HFCK Bank	1.8%	1.9%	2.0%	2.1%	2.0%	2.0%
Jubilee Insurance	1.4%	1.6%	1.3%	1.3%	1.4%	1.4%
KCB Bank	2.5%	3.8%	3.5%	3.1%	3.2%	3.2%
Kenya Reinsurance	4.9%	5.9%	5.7%	5.3%	5.2%	5.4%
NBK Bank	2.6%	2.6%	2.7%	2.8%	2.9%	2.7%
NIC Bank	2.0%	2.6%	2.7%	3.0%	3.2%	2.7%
Olympia Capital	2.0%	2.4%	2.6%	2.7%	3.3%	2.6%
Pan African Insurance	4.8%	4.5%	2.5%	-1.6%	1.8%	2.4%
Standard Chartered Bank	3.4%	3.3%	3.8%	3.3%	3.8%	3.5%

Research Findings

4.3 Firm Performance and Corporate Governance

Investigation as to whether there is a relationship between corporate governance and performance was carried through multiple linear regression. Statistical significance at 95% confidence level was tested for the various correlation coefficients.

ANOVA (analysis of variance) is used to report quantities related to the overall explanatory power and significance of the regression model .Since p-value is less than 0.05(critical level of significance) it is concluded that there is a relationship between Corporate governance and firm performance in financial institutions.

4.3.1 Correlation analysis

Table 4.2 shows correlation coefficients between the various variables of the study. The correlation analysis shows that the four measure of corporate governance measures have some relationships of different strengths with firm performance

The coefficients give estimates of the intercepts and the slope coefficients. The standard error column gives the standard error (the standard deviation) of the estimated regression coefficients.

Table 4.3 Coefficients

Model	Coefficients	Standard Error	t-statistic	p-value
(Constant)	(5.428)	1.562	(3.476)	0.006
BCOM	0.317	0.177	1.786	0.004
SH_COMP	(0.004)	0.228	(0.019)	0.985
SH_RIGHT	0.084	0.127	0.657	0.003
BG_DISCL	0.046	0.204	0.223	0.828

Research Findings

Where-Bcomp - Board composition.

Sh_Comp - Share holding and Compensation

Sh_Right- Shareholder Rights.

Bog_Disc- Board Governance Disclosure

Table 4.3 shows the coefficients of the independent variables. The regression model can be written mathematically as:

ROA= -5.428 + 0.317 Bcomp - 0.004 Sh_Comp +0.084Sh_Right +0.046Bog_Disc

We can therefore argue that corporate governance is related to firm perfomance and the major corporate governance measures that are associated with performance at 0.05 significance level are Board composition and shareholder rights given their small p values of 0.004 and 0.003 respectively as shown on Table 4.3 above

4.3.2 Significance of the model

Table 4.3 shows Adjusted R^2 = 0.803. This means that the model using corporate governance could be used to explain 80% of the variability of performance. We can therefore say that corporate governance has a large bearing on performance.

Table 4.3 R-Squared

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.927	0.859	0.803	0.5

Research Findings

Table 4.4 shows F- value of 15.2792, and f -significance of 0.00029 which means that there is high significance of the model at alpha= 0.05. This means that the model using corporate governance to measure performances can be relied on to explain the variability of operational firm performance in financial institutions.

Table 4.4 Anova Table

Model	Sum of Squares	Degree of Freedom	Mean Square	F-Statistic	p-Value
Regression	15.306	4	3.8264	15.2792	0.00029
Residual	2.504	10	0.2504		
Total	17.810	14			

Research Findings

CHAPTER FIVE:
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter of the study highlights some of the findings, conclusions, recommendations, and suggestions for further study.

5.2 Summary of the findings

Thirteen out of fourteen (93%) of the companies scored high and very high corporate governance scores. This can be attributed to the high regulatory conditions in this industry and the ownership structure in the individual companies.

From the p-values of the correlation coefficients of the four measures of corporate governance, it can be concluded that individually there is a significant relationship between board composition and performance and Share holder rights and performance while the other measures i.e. share holding and compensation and board governance and disclosure are not significantly related with performance.

This implies that Financial Institution should put emphasis on board composition to ensure that the board is constituted with the best corporate governance principles considered and shareholder rights protected

Though the p-value of the correlation coefficients of shareholding and compensation and board governance disclosures indicate that individually these measures are not significantly related to performance, F-test indicated a p-value less than 0.05 implying that there is a positive relationship between corporate governance and firm performance using the model that incorporates all the four components of corporate governance.

5.3 Conclusions

This study investigated the interrelations of corporate ownership and corporate governance, and their effect on firm performance in Financial Institutions. S Financial Institutions face the same external disciplining factors, such as the market for corporate control and the product market, if Financial Institutions internal control mechanisms are determined in an optimal way, a carefully specified empirical analysis should reveal significant links between the different corporate control mechanisms designed to mitigate the scope for moral hazard behavior by managers and firm performance

The findings of the study have established that there is a positive relationship between firm performance and Board composition, Shareholding and Compensation, Shareholder Rights, Board Governance Disclosure issues.

This implies that Financial Institutions that exhibit higher corporate governance standards will perform better than their peers in the same industry.

While there is increasing evidence of failure of certain governance structures to control and motivate managers to increase performance, empirical evidence gathered from this study is mixed and gives little evidence for the shape of an optimal governance structure. One explanation is that the existing theories have not been sufficiently complete to include all major determinants of good corporate governance. Perhaps there will be no optimal governance structure because no two firms, two markets, two legal regimes or two authorities that are exactly the same, resulting in highly complex issues of corporate governance. Ultimately corporate governance is determined by a combination of the above factors and their dynamics.

The way forward is examining corporate governance for Financial Institutions in Kenya, perhaps might be increasing the focus on Shareholder interests and concerns, rather than trying to find some specific mechanisms which are universally applicable foe effective corporate governance.

5.4: Limitations of the study

This study centered in the relationship between corporate governance and firm performance in Financial Institutions listed in NSE. The study did not consider any other factors that inevitably affect performance regardless of corporate governance. Political, environmental and social-economical and technological.

There is the possibility of omission of governance variables that may be relevant in the performance equation or with strong relations to other governance mechanisms. For instance, the extent to which some Financial Institutions rely on subordinated debt may help them reduce agency problems between managers and shareholders, and possibly rely less on other governance mechanisms. Therefore, the system of equations may be mis-specified. Corporate governance theory is, unfortunately, incomplete to help taking into account all relevant mechanisms, when estimating a system of equations of governance mechanisms.

The weighted scores given to each corporate governance element may vary depending on the company size, nature, complexity and hence requiring different scoring.
In this study, same weight was applied to all Financial Institutions regardless of their unique circumstances for ease of comparability.

5.5 Recommendations for policy and practice

Research findings from this study indicate that there is a positive correlation between corporate governance and performance. Therefore the regulators should demand and the board ensures that Financial Institutions meet a certain minimum level of corporate governance. The regulators should also improve on the mechanisms of ensuring that the corporate governance disclosures in the annual repots are not simply statement of good intentions but are actually implemented at firm level. This will greatly improve the level of corporate governance and by extension firm performance.

5.6 Recommendations for further research

Companies quoted in NSE are obliged by CMA and NSE to declare various aspects of corporate governance to their shareholders. A study of the extent of corporate governance to performance in Financial Institutions not quoted and hence not subjected to CMA, will provide more insight to corporate governance in Financial Institutions in Kenya.

Measures used in this study were not exhaustive and therefore a study based on different measure of performance can either confirm or otherwise the findings of this study**.**

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Appendix A: Letter of Introduction

Dear Respondent,

I am a student pursuing a Master of Business Administration [MBA], Finance degree at the School of Business, University of Nairobi. My study intends to examine how performance in financial institutions is influenced by corporate governance.

The questionnaire attached asks questions about the institution corporate governance indicators. Based on your experience and knowledge, please indicate the most appropriate Response.

Your participation is essential to this study and will enhance our knowledge of corporate governance in financial institutions in Kenya. I also wish to assure you that all information with respect to this research will be treated with the strictest confidence it deserves and will only be used for academic purposes, and in no circumstance will your name be mentioned in the report without your prior permission. If you would like, we can send you the report of the findings on request.

Kindly assist in providing the required information. Thank you very much.

Oyoga Benard. [MBA Student]
P.O Box 387
00510- Nairobi.
Tel. 0720-146061

Mr. James Ng'ang'a. [Supervisor]

Appendix B: Interview questionnaire

1 Name of the Company…….

Job Title…….....……

2 Number of years in management in this organization……

3 How do you grade your organization in the following statements? (Tick where applicable)

		TICK
Corporate Governance Measure	**Measure**	
A) Board composition		
Percentage of Directors fully independent (are not management, relatives to, or do business with the company.	>67%	
	>50%	
	< 50%	
Percentage of Audit committee fully independent.	>67%	
	>50%	
	< 50%	
Percentage of Compensation committee (committee that determines executive pay) that is fully independent.	>67%	
	>50%	
	< 50%	
Percentage of Nomination committee(recommending new directors to join the board) fully independent	>67%	
	>50%	
	< 50%	
Role of chairperson and CEO split.	Yes	
	No	
Two or more directors sit together on two or more boards of NSE companies	No	
	Yes	
Directors sit on six or more NSE company boards	No	
	Yes	
Women on the board	1/3 or more	
	At least one	
	None	

The board have a system to evaluate its performance	Yes	
	No	
The board have a system to evaluate individual performance	Yes	
	No	
Independent directors meet without management	Yes	
	No	
B) Share holding and Compensation		
Directors required owning shares or sharing units.	Yes	
	No	
How many shares to directors own	Maximum	
	< required	
CEO required to own shares	Yes	
	No	
Does the CEO own shares?	Maximum	
	< required	
Company give loans to its senior executives	Yes	
	No	
Does the company disclose the compensation policies	Yes	
	No	
C) Shareholder Rights		
Shareholders to vote for individual directors, or only the entire slate of nominees	Individual Directors	
	Entire slate	
Period before options can be exercised	Yes	
	No	
Company award options to directors	No	
	Yes	
Performance hurdles that must be met before stock options can be exercised	Yes	
	No	
Non-voting or subordinate voting shares	No	
	Yes	

D) Board Governance Disclosure issues		
Company provide a full explanation of which directors are related and unrelated and why	Yes	
	No	
Company disclose how much the auditor is paid for consulting and other services	Yes	
	No	
Company disclose detailed biographies to explain directors' qualifications to represent shareholders	Yes	
	No	
Company list other public company boards the directors sit on	Yes	
	No	
Company disclose director attendance records at board meetings	Yes	
	No	
Company disclose how often the board and its committees meet last year	Yes	
	No	

Thank you for your cooperation.

Appendix C: Financial Institutions listed in NSE

Barclays Bank of Kenya Ltd
CFC Stanbic Bank Ltd
Diamond Trust Bank of Kenya Ltd
Housing Finance Company of Kenya Ltd
ICDC Investment Company Ltd
Jubilee Holdings Insurance Co. Ltd
Kenya Commercial Bank Ltd
National Bank of Kenya Ltd
National Industrial Credit Bank Ltd
Pan Africa Insurance Holdings Co. Ltd
Standard Chartered Bank Ltd
Equity Bank
Kenya Re Corporation
Olympia Capital Holdings
Co-Op Bank of Kenya

Appendix D: Corporate Governance Scores

Corporate Governance Measure	Measure	Rank	Max %
A) Board composition			41%
Percentage of Directors fully independent (are not management, relatives to, or do business with the company.	>67%	8%	8%
	>50%	4%	
	< 50%	0%	
Percentage of Audit committee fully independent.	>67%	6%	6%
	>50%	2%	
	< 50%	0%	
Percentage of Compensation committee (committee that determines executive pay) that is fully independent.	>67%	6%	4%
	>50%	2%	
	< 50%	0%	
Percentage of Nomination committee(recommending new directors to join the board) fully independent	>67%	3%	3%
	>50%	2%	
	< 50%	0%	
Role of chairperson and CEO split.	Yes	5%	5%
	No	3%	
Two or more directors sit together on two or more boards of NSE companies	No	3%	3.00 %
	Yes	0%	
Directors sit on six or more NSE company boards	No	2%	2%
	Yes	0%	
Women on the board	1/3 or more	3%	3%
	At least one	1%	
	None	0%	
The board have a system to evaluate its performance	Yes	2 %	2%
	No		
The board have a system to evaluate individual performance	Yes	2%	2.%
	No		
Independent directors meet without management	Yes		3%
	No		
B) Share holding and Compensation			**20%**

Directors required owning shares or sharing units.	Yes	4%	4%
	No	0%	
How many shares to directors own	Maximum	4%	4%
	.-1 for < req		
CEO required to own shares	Yes	3%	3%
	No	0%	
Does the CEO own shares?	Maximum	3%	3%
	.-1 for < req	0%	
Company give loans to its senior executives	Yes	2%	2%
	No	0%	
Does the company disclose the compensation policies	Yes	4%	4%
	No	0%	
C) Shareholder Rights			**24%**
Shareholders to vote for individual directors, or only the entire slate of nominees	Individual Directors	4%	4%
	Entire slate	0%	
Period before options can be exercised	Yes	3%	3%
	No	0%	
Company award options to directors	No	3%	3%
	Yes	0%	
Performance hurdles that must be met before stock options can be exercised	Yes	4%	4%
	No	0%	
Non-voting or subordinate voting shares	No	10%	10%
	Yes	0%	
D) Board Governance Disclosure issues			15%
Company provide a full explanation of which directors are related and unrelated and why	Yes	3%	3%
	No	0%	
Company disclose how much the auditor is paid for consulting and other services	Yes	3%	3%
	No	0%	
Company disclose detailed biographies to explain directors' qualifications to represent shareholders	Yes	2%	2%
	No	0%	

Company list other public company boards the directors sit on	Yes	2%	2%
	No	0%	
Company disclose director attendance records at board meetings	Yes	2%	2%
	No	0%	
Company disclose how often the board and its committees meet last year	Yes	3%	3%
	No	0%	