RELATIONSHIP BETWEEN SELECTED CORPORATE BOARD DYNAMICS AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

I declare that this research is my original work and has not been previously published or submitted elsewhere for award of a degree. I also declare that this project contains no material written or published by other people except where due reference is made and author duly acknowledged.

Signed: ……………………………….. Date ……………………………………

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This Research Project has been presented for examination with my approval as a university supervisor.

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DEDICATION

To my daughter Adriel, keep the spirit of academic prosperity as you pass the torch of knowledge from this generation to the next generation. Keep it burning!

ABSTRACT

Commercial banks in Kenya have gone through a number of challenges in their quest to achieve high levels of performance. Corporate Board Dynamics is one category of corporate governance that focuses on how the organization performs in that it gives a strategic direction in which an organization is to take. The objective of the study was to determine the relationship between selected corporate board dynamics and financial performance of commercial banks in Kenya. The board dynamics studied were: - Board size, composition of executive and non-executive members and the gender diversity in corporate boards. The study adopted a descriptive research design and the study population was 43 licensed Commercial Banks in Kenya as at December 2013. A census survey was conducted for the five years from 2009 to 2013.The study found that the overall regression model for firm performance based on return on assets is significant. This means that the independent variables studied are important predictors of commercial banks financial performance when firm size is incorporated as a control variable. It was also found that the average board size for the Kenyan commercial banks is 10 board members with and the average number of executive board members is 3 and an average of one women representation in the boards of commercial banks.The study concludes that the independent variables namely board size; board composition and gender diversity are significant predictors of the financial performance based on the research model. It is therefore important that the right mix of these variables be put in place in order to maximize financial performance of the commercial banks in Kenya.

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LIST OF ABBREVIATIONS

AGM -Annual General Meeting

ANOVA – Analysis of Variance

CBK - Central Bank of Kenya

CEO – Chief Executive Officer

CMA - Capital Markets Authority

NSE – Nairobi Securities Exchange

OECD - Organization for Economic Co-operation and Development

ROE – Return on Investment

S&P - Standard and Poor's

SOX - Sarbanes-Oxley

UK – United Kingdom

US - United States of America

CHAPTER ONE

INTRODUCTION

1.1. Background to the Study

Commercial Banks in Kenya have gone through a number of challenges in their quest to achieve high levels of performance. Corporate Board Dynamics is one category of corporate governance that focuses on how the organization performs in that it gives a strategic direction in which an organization is to take. Smith (1776) laid the foundation on few aspects of organization theory. Smith predicted that if an economic firm is controlled by a person or group of persons other than the owners, the objectives of the owners are likely to be diluted than ideally fulfilled.

Berle and Means (1992) noted that with the separation of ownership and control, and the wide dispersion of ownership, there was effectively no check upon the executive autonomy of corporate managers. Furthermore the board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment. Given that board dynamics as part of good governance contributes on performance of organizations, this study seeks to investigate the relationship between board dynamics on financial performance of commercial banks operating in Kenya. The objective of this study is to determine whether board dynamics play a role in determining financial performance of commercial banks in Kenya.

1.1.1. Board Dynamics

The corporate governance literature indentifies four sets of board's attributes; namely, composition, characteristics, structure and process (Abor, 2007). According to Francis (2000) the concept of corporate governance gained prominence in the 1980s because this period was characterized by stock market crashes in different parts of the world and failure of some corporations due to poor governance practices. Corporate collapse was the predominant driver for change to corporate governance codes (United Nations, 1999). As more corporate entities in different parts of the world collapsed in 1980s, there was a change of attitude with much higher performance expectations being placed on management boards of firms. There was also a growing realization that managers are to run firms while boards are to ensure that firms are run effectively and in the right direction (Adams, 2002). Therefore directors and managers require different sets of skills and managers do not necessarily make good directors.

Fama and Jensen (1983) characterized the responsibilities of board of directors as being both ratification of management decisions and monitoring of management performance. There is therefore a risk of managerial collusion if majority of board members are internal. According to Fama (1980) this may be reduced by the presence of outside directors who may be regarded as an alternative source of corporate monitoring. However, against the above hypothesis on board composition being a source on monitoring, Demsetz (1983) noted that different monitoring mechanisms may be used in an optimal way, in which case no relation between these and performance would be

observed. Other studies established strong links between the performance of corporations and the governance practices of their boards (Gregg, 2001; Hilmer, 1998; Kiel & Nicholson, 2002; OECD, 1998).

1.1.2. Financial Performance

According to Wheelen and Hunger (2002) financial performance is the outcome of all the organization's operations and strategies, it is the extent to which a firm increases sales and profit, return on equity and return on assets. Sousa and Voss (2002) also observe that financial performance is essential to the survival of firms in the competitive and uncertain environment. The management is therefore interested in understanding how the effort of service quality improvement is related to an organization's performance. Klammer (1973) outlined financial performance to be results obtained from revenues and expenses analysis as an indicator of financial health status or measure of profitability.

Since their inception companies have used various yard sticks for measuring and reporting financial performance. The two main items used to measure financial performance are firms market share within a particular industry in which it operates and its profitability. Profitability is then used to measure the company return on capital employed hence value to shareholders. Accountants and economists have derived and used various financial ratios to assess company financial performance. These ratios mainly involve company liquidity – cash flow Liquidity ratio, debt management – Financial leverage index, asset management – Return on total assets, profitability – cash flow margin and finally return on investment – dividend yield (Brealey, 2003).

1.1.3. Board Dynamics and Financial Performance

The relationship between corporate board dynamics and financial performance has been a discussion financial scholarly issue for a long time. This has led scholars and policy makers to believe that boards of director's attributes may have an influence in strategic decision-making and subsequently firm performance. Some scholars have argued that different board of directors attributes impact organizational performance differently owing to their different orientations (Hermalin & Weisbach, 2003). Some of board of director attributes includes the visible and less visible types of diversity. According to Milliken & Martins (1996) the visible dynamics includes member's age, chief executive officer duality and gender while less visible diversity relates to underlying attributes of education, technical capabilities, skills, knowledge, occupational background and range of industry experience.

Jensen and Meckling (1976) Agency Theory argues that in firms where equity is widely held, managerial actions tend to depart from the requirements of shareholders. Donaldson and Davis (1994) Stewardship Theory contends that Managers are good stewards of corporations and diligently work to attain high levels of corporate profit and shareholders returns. Clarkson (1994) in defining Stakeholder Theory contends that the purpose of the firm is to create wealth or value for its stakeholders and managers in organizations have a network of relationships to serve. Adoption of good governance is vital in all institutions, according to Jebet (2001) lack of proper management in the institutions results to collapse of the organizations. Key among governance structures is the corporate board,

Jensen and Meckling (1976) have proven that organizations with better corporate governance practices might have more efficient operations, resulting in a higher expected future cash-flow stream.

Among the results of bad governance by the management is the risk of hostile takeovers; According to Shivdasani (1993) hostile takeovers provide discipline when internal governance mechanisms such as board of directors fail to control management's non value maximizing behavior. This therefore explains why the board should take leadership in governance issues. According to Goodstein et al. (1994) corporate boards fulfill three major tasks; it links the organization to its environment and secures critical resources, the board also has internal governance and monitoring task and lastly it can discipline or remove ineffective management teams.

1.1.4. Commercial Banks in Kenya

The commercial banks in Kenya are licensed and regulated pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines issued there under. Since they are the dominant players in the Kenyan banking system, closer attention is paid to them by the Central Bank of Kenya (CBK). The banking industry is also governed by the Companies Act. According to CBK (2014) as at December 2012 there were 43 licensed Commercial banks in Kenya with Central Bank of Kenya as the regulating authority. Out of the 43 commercial banks, 31 are locally owned and 12 are foreign owned. The locally owned financial institutions comprise 3 banks with significant shareholding by the Government and State Corporations.

The banking industry in Kenya has been very vibrant with majority of banks recording good performance as measured by increasing customer base and financial performance based on profitability. According to CBK (2014) The Kenyan banking sector registered improved performance in 2013 notwithstanding the marginal economic growth. The sector registered a 15.9 percent growth in total net assets from Ksh. 2.33 trillion in December 2012 to Ksh. 2.70 trillion in December 2013. Equally, customer deposits grew by13.5 percent from Ksh. 1.71 trillion in December 2012 to Ksh. 1.94 trillion in December 2013.

1.2. Research Problem

According to McLaney (2009) a way of understanding financial performance of a firm is to gather insight on business performance, its useful to calculate ratios to measure performance trend of the firm over a period and industrial comparison against other firms. Many benefits accrue from good financial performance of banks. Most of these benefits accrue to various stakeholders of these banks. This means that the shareholders get more wealth due to high returns on investment, employees get their dues in form of salaries and wages, government gets taxes among other stakeholders when there is good financial performance.

The relationship between corporate board dynamics as a key governance structure and financial performance has been a discussion financial scholarly issue for a long time. Jensen and Meckling (1976) Agency Theory argues that managers actions tend to depart

from the requirements of shareholders of good financial performance. While Donaldson and Davis (1994) Stewardship Theory contends that Managers are good stewards of corporations and diligently work to attain high levels of corporate profit and shareholders returns. Clarkson (1994) Stakeholder Theory contends that manager's serve a number stakeholders of organizations who have an interest in good financial performance.

Globally, scholars McIntyre, Murphy, & Mitchell (2007) sought to examine the relationship between key board composition variables and firm performance. Their study revealed that high levels of experience, appropriate board size; moderate levels of variation in age and team tenure were correlated with firm performance. Another study conducted by Dalton, Daily, Ellstrand & Johnson (1998) showed that board composition had virtually no effect on a firm s performance and that there is no relationship between leadership structure and firm performance. Rechener and Dalton (1983) opines that separations of roles of CEO and firm's chair position results in higher ROE and profits margins. According to Donald and Davis (1991) the independence of the chair, board structure and Financial incentives given to the CEO's has no effect on the financial performance as measured by ROE thereby contradicting Rechener and Dalton proposition.

Locally, Maina (2005) examined the effects of board composition on firms performance on all quoted firms in Kenya and found no significant relationship between firm's performance and board composition. Okiro (2006) examined the relationship between

board size and board composition on firm performance of quoted companies at the NSE. He found that there was no significant relationship between board size and firm valuation. Ekadah and Mboya (2012) also conducted a study to analyze the effect of board gender diversity on performance of commercial banks in Kenya. The proportion of female directors was found to have negative relationship with bank performance. Wetukha (2013) conducted a study to establish the relationship between board composition and financial performance of companies listed in NSE. The study found a positive relationship between board independence, board size and CEO duality and financial performance. However, gender diversity and the proportion of executive directors were found to have negative relationship.

The above studies indicate that this area has not been conclusively researched on; the theoretical and empirical findings are conflicting and inconclusive which has necessitated the current study. Although these previous studies have focused on the role of corporate governance on financial performance, these studies have largely dealt with a simplistic approach of relating the entire spectrum of corporate governance which in many cases has been a concept that is not very well understood to financial performance**.** According to the researcher no studies have been carried out locally on this causal relationship that may exists between corporate board dynamics and financial performance of the commercial banks operating in Kenya. The study therefore aims at filling this gap by answering the following research question: Is there a relationship between corporate board dynamics and the financial performance of commercial banks in Kenya?

1.3. Research Objective

To determine the relationship between selected corporate board dynamics and financial performance of commercial banks in Kenya.

1.4. Value of the Study

The study provides important insights to commercial banks in Kenya, other related organizations, and policy makers in the banking/financial sector and also contribute to scholarship by providing further empirical evidence on this area. This study adds more knowledge on the wider concept of corporate governance. It also provides clarity on the relationship that exists between board dynamics and financial performance of commercial banks in Kenya.

This study provides additional literature that will be of value to scholars, students and researchers and can be used as basis of further research on the area of specific contribution that various governance issues have on financial or any other measure of performance to various sectors of the economy. Moreover this study provides insights on specific variables of corporate board dynamics and their relationship with financial performance of commercial banks and other firms operating in the Kenyan financial sector. These findings can further be applied by policy makers in the financial sector in developing policies, guidelines and regulations.

CHAPTER TWO

LITERATURE REVIEW

2.1. Introduction

This chapter discusses the literature related to relationship between corporate board dynamics and financial performance. Its presentation starts with the theoretical literature then empirical literature and the researcher’s conclusion. According to Mugenda and Mugenda (2003) Literature review involves the systematic identification, location and analysis of documents containing information related to the research problem being investigated. The objective is to gain a deeper understanding of the history, evolution and direction which provides justification in revealing the knowledge gap necessitating this study.

2.2. Theoretical Review

This section reviews the various theories related to Corporate Board Dynamics. This includes the Agency theory, Stewardships theory and Shareholders theory.

2.2.1. The Agency Theory

The agency relationship as described by Jensen and Meckling (1976) identifies the agency relationship where one party, the principal (shareholders), delegates duties to another party, the agent (Board of Directors and the managers). The theory argues that in firms where equity is widely held, managerial actions tend to depart from the requirements of shareholders which are to maximize their wealth, this creates the agency

problem. The theory holds the proposition that in the presence of information asymmetry where the agent actions may end up hurting the owners.

Eisenhardit (1989) the agency problem arises when; the desires or goals of the principal and agent conflict and when it is difficult or expensive for the principal to verify what the agent is actually doing. The problem is that the principal is unable to verify that the agent is behaving appropriately and in his best interest. According to Shleifer and Vishny (1997) agency problem can be explained in the context of an entrepreneur or a manager who raises fund for investors to put them in productive use. But how can the financiers be sure that once they sink their funds they will get everything back from the manager?

Jensen and Meckling (1976) demonstrated how investors/shareholders in publicly traded corporations incur costs in monitoring and bonding managers to the best interest of shareholders. They defined the agency costs as being the sum of costs of: monitoring management (agent); bonding the agent to the principal (shareholder): and the residual losses. According to Fama and Jensen (1983) the clear implication of corporate governance from the agency theory perspective is that adequate monitoring and control mechanisms need to be established to protect stakeholders from management conflict of interest.

In order to minimize agency problems Jensen (1983) proposes that the principal agent risk bearing mechanism must be designed efficiently and that the design must be

monitored through a nexus of organizations and contracts. The inevitable loss of firm value that arises with agency problem with the costs of contractual monitoring and bonding are defined as agency costs (Jensen and Meckling, 1976). Therefore from the agency perspective, Boards of Directors are put in place to monitor management on behalf of shareholders (Eisenhardt, 1989; Jensen and Meckling, 1976)

Agency problem may affect the value of a company through two ways; the expected cash flows accruing to the company and the cost of capital. Jensen (1986) proposes a theory that good governance reduces the resources under the control of manages and indirectly reduces the chance of expropriation by managers, also good governance decreases the cost of capital either through the reduction of shareholders monitoring and auditing costs. The share price that the shareholder (principal) pays reflects such agency costs. To Increase firm value one must therefore balance the agency costs against the benefits expected to accrue to the firm by incurring such costs.

2.2.2. Stewardship Theory

Stewardship theory contends that "Managers are good stewards of corporations and diligently work to attain high levels of corporate profit and shareholders returns" (Donaldson and Davis, 1994). One of the requirements of company law is that directors should demonstrate fiduciary duty to the shareholders of the company. This is based ion assumption that directors having fiduciary duty can be trusted and will act as stewards over the resources of the company. Therefore the duties of a director is based on

stewardship theory which is a higher duty than that of an agent as the person must act as though he were the principal rather than a representative of the principal.

Donaldson and Davis (1994) further explains that managers are principally motivated by achievement and responsibility need and therefore, given the needs of managers for responsible, self directed work; organizations maybe better served to free managers to subservience to non executive director dominated boards. Underlying this theory is the assertion that since managers are naturally trustworthy there will be no major agency costs (Donaldson, 1990; Danaldson and Preston, 1995). Stewardship theorists also argue that senior executives will not disadvantage shareholders for fear of jeopardizing their reputation (Donaldson and Davis, 1994). Proponents of stewardship theory argue that the board should have a significant proportion of inside directors to ensure more effective and efficient decision making.

2.2.3. Stakeholder Theory

Clarkson (1994) in defining stakeholder theory states that "the firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services". Unlike agency theory in which the managers are working and serving for the shareholders interests, stakeholder theorists suggest that managers in organizations have a network of relationships to serve this include the suppliers, employees and business

partners. This view is also supported by Blair (1995). This theory states that managers should make decisions that take account of the interest of all the stakeholders in the firm.

There are two main theories of stakeholder governance: the abuse of executive power model and the stakeholder model. Current Anglo-American corporate governance arrangements vest excessive power in the hands of management who may abuse it to serve their own interest at the expense of shareholders and society as a whole (Hutton, 1995). Supporters of such a view argue that the current institutional restraints on managerial behavior, such as non-executive directors, the audit process, the threat of takeover, are simply inadequate to prevent managers abusing corporate power. Shareholders protected by liquid asset markets are uninterested in all but the most substantial of abuses.

The goal of corporate governance is to maximize the wealth creation of the corporation as a whole. Specifically, a stakeholder is defined as “any group or individual who can affect or is affected by the achievement of the firm's objectives” (Freeman, 1984,), and this is “meant to generalize the notion of stockholder as the only group to whom management need to be responsive” (Freeman, 1984). These definition as formulated form the basis that modern corporation is affected by a large set of interest groups, including at a minimum shareholders, lenders, customers, employees, suppliers and management, which are often referred to as the primary stakeholders, who are vital to the survival and success of the corporation. To these the corporation adds secondary stakeholders, such as

the local community, the media, the courts, the government, special interest groups and the general public, that is society in general.

From this perspective, corporate governance debates often proceed with a fixation on the relationship between corporate managers and shareholders, which presupposes that there is only one right answer. In fact, shareholders are difficult and reluctant to exercise all the responsibilities of ownership in publicly held corporations, whereas other stakeholders, especially employees, may often too easily exercise their rights and responsibilities associated as owners. This is a compelling case for granting employees some form of ownership.

2.3. Determinants of Financial Performance of Commercial Banks

Financial performance is an objective measure of a firms overall financial health over a given period of time and can also be used to compare similar firms across the same industry or compare industries or sectors in aggregation. This study sought to analyze determinants of financial performance as follows:

2.3.1. Capital Structure

Capital structure refers to the way in which an organization is financed a combination of long term capital (ordinary shares and reserves, preference shares, debentures, bank loans, convertible loan stock and so on) and short term liabilities such as a bank overdraft and trade creditors. A firm's capital structure is then the composition or 'structure' of its liabilities Nirajini (2013). Capital structure plays a role in determining the

risk level of the company, and fixed cost is the key factor whether it is involved in production process or fixed financial charges. The financing or capital structure decision is significant managerial decision, as it influences the shareholder return and risk Nirajini (2013)

2.3.2. Corporate Board Dynamics

Board dynamics revolve around variables such as size of the board, duality of CEO/ Board Chair, gender composition of the board, independence of board of directors, frequency of board meetings, CEO chair duality, and gender diversity among others. The board of directors is an important determinant of performance in that the board is the highest internal decision control system in an organization. According to John and Senbet (1988) boards of directors perform three important roles namely: Control, Service and Resource Dependence. Mululu (2005) opines that board activity is positively related to the financial performance of firms suggesting that board activity is a value relevant attribute in corporate governance. Jensen & Meckling (1976) explained that the use of a board of directors reduces agency costs and in effect a cost reduction in administration of the firm.

2.3.3. Firm Size

The size of a firm affects performance in many ways. Key features of a large firm are its diverse capabilities, the abilities to exploit economies of scale and scope and the formalization of procedures. These characteristics, by making the implementation of operations more effective, allow larger firms to generate superior performance relative to

smaller firms (Amato and Wilder, 1990). The number of employees is one of the common measures of firm size (Konrad & Mangel, 2000).

Economic theory prescribes that increasing firm size allows for incremental advantages since the size of the firm enables it to raise the barriers of entry to potential entrants as well as gain leverage on the economies of scale to attain higher profitability. For example, in the case of banking sector in Kenya, a new entrant has little choice but to incur substantial fixed costs in gaining entry to the industry, in the form of acquiring and maintaining set capital requirements and investments in capital equipment to provide services to customers in addition to advertising extensively to let customers know that it is in the market.

2.3.4. Macroeconomic Variables

Given the increased financial and economic integration that prevails today, no firm can claim any longer to be unaffected by what is happening on the global economic arena. Macroeconomic variables like interest rate, inflation rate and political risk have a bearing on how a firm performs. The industry in which a corporation exists has a significant effect on its financial performance. Porter (2008) argues that it's a major determinant of financial performance and its changes may vary across industries. The effect generated by the realization of a political risk for example is often treated in accounting as an extraordinary item.

Several studies have shown the problem in using “extraordinary items” in this context as an instrument for the smoothing out of income (Dempsey, Hunt and Schroeder, 1993). Researchers in the economics field have offered a variety of models for analyzing financial performance. However, little consensus has emerged on what constitutes a valid set of performance criteria (Tangen, 2003).

2.4. Empirical Studies

A number of studies have been carried out on the relationship between corporate board and performance, some of these studies focused on the corporate governance generally and financial performance.

Raymond et al. (2010) conducted a study on influence of corporate boards on firm financial performance in the new era of Sarbanes-Oxley (SOX). The independent variables were: duality, proportion of outside directors, gender/diversity, board members average age, average board tenure, board size, and occupational expertise. For each dependent variable, they calculated the change from 2006 to 2007. They tested their hypotheses with data from Standard and Poor’s (S&P) 500 companies. The data was analyzed using hierarchical regression analysis in two comparison models for each firm performance variable. The research found out that models showed their hypothesized boards of director’s compositions are significant in explaining changes in revenue, ROA, financial leverage, and free cash flow-to-income.

Lacker et al. (2006) contends that firm performance can be explained by fourteen dimensions of corporate governance using a sample of 2106 firms and 39 structural measures of corporate governance. The study was conducted using empirical examination between typical measures of corporate governance and various accounting and economic outcomes which failed to produce consistent results. This was attributed to difficulty in generating reliable and valid measure of complex contrast of corporate governance practices. They concluded that the dimensions of corporate governance they had identified had to some extent an ability to explain future operating financial performance and future excess stock returns. This indicated that good corporate governance practices can be associated with good financial performance.

Rashid et al. (2010) examined the influence of corporate board composition in the form of representation of outside independent directors on firm economic performance in Bangladesh. Two hypotheses were developed to examine the relationship among composition of board memberships including independent directors and firm performance. An observation of 274 Bangladeshi firm-years was used in the study. They used a linear regression analysis to test the hypotheses. Results revealed that the outside (independent) directors cannot add potential value to the firm's economic performance in Bangladesh. The idea of the introduction of independent directors may have benefits for greater transparency, but the non-consideration of the underlying institutional and cultural differences in an emerging economy such as Bangladesh may not result in economic value addition to the firm.

Drobetz (2003) conducted a study in Germany focusing on the relationship between firm performance, (Tobin's Q and Market-to-Book value) and multifactor corporate governance rating, covering the period 1998-2002 which was based on responses to objective survey questions. To construct their sample, they sent out a questionnaire to 253 firms in Germany and they received answers from about 91 firms. Using multiple regression analysis they found significant empirical evidence for a positive relationship between firm performance and this multifactor corporate governance rating.

Lishenga (2011) investigated how corporate governance practices of firms listed in the NSE change as a remedial action to persistent fall in financial performance. The study population was all firms listed in the NSE from 1998 to 2005. Samples were drawn from calculated Tobin’s Q values of these firms at the end of 1998 to 2004. These were grouped into Winners and losers. Secondary data was collected and analyzed by descriptive statistics. He found out that board meeting frequency increased with declining performance. He also found that insider ownership falls with falling firm’s financial performance. He however concluded that company’s respond to declining financial performance by changing governance structures.

Kerich (2006) studied governance structures and performance of firms quoted in Nairobi Stock Exchange. He evaluated weather corporate governance practices of these firms were responsive to declining financial performance. The study population was all the 47

companies listed in the NSE for the period of five years from 2000 to 2005. A cross sectional survey design that sought to identify differences in governing structures between companies facing decline in value, those with appreciating value and those with stable values was used. Secondary data was used and analyzed using two approaches; descriptive statistics was used and validated with regression analysis. The study found out that there is a positive relationship between financial performance and frequency of board meetings, percentage of insider directors and executive compensation.

Chogii (2009) conducted a study to investigate whether there is a relationship between board attributes; board size, board composition and CEO duality against firm financial performance as measures by ROA and Tobin's Q . His study was investigating these variables from a standpoint of two competing theories of corporate governance i.e. Agency theory and Stewardship theory. The study population was companies listed in the NSE over a study period of year 2004 to 2007. He used secondary data collected from published annual reports of these companies. Data was analyzed using descriptive statistics and regression analysis. He found out that most firms studied tended to have outside dominated boards with preference of outside directors being twice as much as inside directors from the firms studied. He also found out that using Tobin's Q as a measure of financial performance board composition was found to influence firm's financial performance with the number of outside directors being a significant variable.

Mang'unyi (2011) studied the Ownership Structure and Corporate Governance and Its Effects on Performance, a Case of Selected Banks in Kenya. The population of the study comprised of banks operating within Nairobi city in Kenya. A stratified sampling methodology was used to select the banks to be studied. Primary data was collected administered to selected bank managers and analyzed using descriptive methods. He found out that there is no significant difference between type of ownership and financial performance and further found out that there exists significance difference between corporate governance and financial; performance.

Ekadah and Mboya (2012) conducted a study to analyze the effect of board gender diversity on performance of commercial banks in Kenya for the period 1998-2009 The study adopted explanatory correlation research design. The target population for this study was the forty four commercial banks in Kenya. The data was obtained from secondary sources. Stepwise regression was used to analyze the effect of board diversity on performance. The study found that boards of commercial banks in Kenya are male-dominated and on average, out of a typical board size of 8 members, only 1 is a female director. The Proportion of female directors was found to have negative relationship with bank performance just as was the case with presence of female directors on the board. Their findings concluded that board diversity is negatively, although not statistically significant, related to performance of banks in Kenya.

Wetukha (2013) conducted a study to establish the relationship between board

composition and financial performance of listed firms at the Nairobi Securities Exchange. This study examined board size, gender diversity, board independence and CEO duality and how they affect the financial performance of listed firms in Kenya. Firm performance was measured using Return on Assets (ROA). This study adopted a descriptive research design and data was analyzed using a multiple linear regression model. The study population was all the firms quoted at the Nairobi Securities Exchange from January 2008 to December 2012. Secondary data was. The study found a positive relationship between board independence, board size and CEO duality and financial performance. However, gender diversity and the proportion of executive directors were found to negatively affect the financial performance of companies listed at the NSE.

2.5. Summary of Literature Review

From the studies reviewed there is no one general model that can best describe the relationship between corporate board dynamics and financial performance. There is also no consensus between the competing theories reviewed in the literature i.e. agency theory, stewardship theory and stakeholders theory on the relationship between the governance aspect of board dynamics and financial performance. Empirical evidence reviewed relating the corporate board and financial performance also has given mixed results, some show a positive correlation while others argue that board dynamics is uncorrelated with firm’s financial performance. Therefore the strategic role that the board plays in the firm's governance structure needs be critically studied with a view to isolate those variables of board dynamics that positively contribute to firm’s financial success.

Majority of studies reviewed focused on developed countries which may not present exact scenario if these studies were to be conducted in a developing country like Kenya. The studies that have been conducted locally focused on the entire spectrum of corporate governance and focused on industries other than commercial banks. This study is therefore be different in that it focuses on a certain category of corporate governance i.e. board dynamics and relate it to financial performance of commercial banks in Kenya an area that according to the best knowledge of the researcher has not been studied.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction

This chapter presents the researchers plan it terms of the methodology and tools on how this study was conducted. Kothari (2003) asserts that the purpose of research methodology is to give details regarding procedures used in conducting the study. The sections presented here include: Research design, population, data collection and analysis.

3.2. Research Design

This study adopted a descriptive survey research design. Mugenda and Mugenda (1999) defines survey method as an attempt to collect data from a representative sample of the population in order to determine the current status of the population with respect to one or more variables and generalize its findings. It involves finding out how one variable affects changes in the other one or more variables. According to Orodho (2004) the choice of descriptive survey research design is made based on the fact that the study variables the researcher is interested in already exist and therefore no manipulation of variables is necessary. The research is a cross sectional survey of all commercial banks in Kenya with an aim of finding out whether there is any relationship between the independent variable of corporate board dynamics and dependent variable which is financial performance

3.3. Population and Sample Size

The study population was 43 licensed Commercial Banks in Kenya as at December 2013. A sample size refers to the number of elements to be included in a study. According to Mugenda and Mugenda (1999) sometimes the target population may be too small that selecting a sample may be meaningless and therefore taking a census may be advisable. To obtain a minimum population sample for this study the researcher conducted a census.

3.4. Data Collection

The study used secondary data based on annual financial statements and reports of the commercial banks. The use of commercial banks is due to data availability and reliability of data since all commercial banks are required by law to publish their annual reports.

The data was collected from the year 2009 to 2013 and focused on the financial statements and annual reports and ratios computed there from.

3.5. Study Variables

3.5.1. Independent Variables

Board size – The total number of Board Members

Board Composition – Executive Board Members / Non Executive Board Members

Gender Diversity – Number of Women in the Board / Total Board Membership

3.5.2. Dependent variables

Return on Assets - Net Income / Total Assets

3.5.3. Control Variables

Firm size, the total assets owned by the firm: Measured as the natural logarithm of Total Assets.

3.6. Data Analysis

The study used descriptive statistics and multiple regression analysis to analyze data. According to Mugenda and Mugenda (1999) the purpose of descriptive statistics was to enable the researcher to meaningfully describe a distribution of scores or measurements, using a few indices. The use of multiple regression analysis is explained by Kothari (2004) the main objective of using this technique is to predict the variability the dependant variable based on its covariance with all independent variables. To determine financial performance of commercial banks financial ratio Return on Assets was used.

Return on Assets = Net Income / Total Assets

Multiple regression analysis was performed on Return on Assets to test the relationship between the independent variables with the firm's financial performance. This relationship was analyzed using Pearson correlation coefficient and regression analysis. The tests that were performed are the f-test and t-test. F-test was used to test the overall significance of the regression model while t-test was used to test the significance of independent variables in the model. The analysis was based on confidence limits of 95% on a two tailed test significance level of 0.05. For any test to be significant the P -value should be less or equal to 0.05 or better using two tailed test.

The equation to establish the relationship between corporate board dynamics and financial performance of commercial banks in Kenya was;

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

Where:-

Y - Financial Performance measured by Return on Assets

X_1 - Board Size (Total Number of Board Members)

X_2 - Measure of board composition (Ratio of executive Board members over total number of board members)

X_3 - Measure of Gender Diversity of the Board (percentage of women in the board to total number of board members)

X_4 - Firm size, the total assets owned by the firm: Measured as the Natural Logarithm of total assets.

α - Constant term explained by other factors affecting financial performance other than corporate board dynamics

$\beta_1, \beta_2 \ldots\ldots\ldots \beta_4$ – Beta Coefficients (independent variables /Board attributes of interest)

e - Error term associated with exogenous noise and the unobservable feature.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1. Introduction

In this chapter the study provided for two types on data analysis methods namely: descriptive analysis and inferential analysis. The descriptive analysis helps the study to describe the relevant aspects of the phenomena being studied and provides detailed information about each relevant variable. For inferential analysis the study used Pearson correlation, the panel data regression analysis and the t-test statistics. While Pearson correlation measures the degree of association between variables under consideration, the regression estimates the relationship between study variables which were; selected corporate board dynamics and commercial banks financial performance.

4.2. Response Rate

The researcher collected secondary data from the annual reports and the financial statements of all the 43 commercial banks in Kenya. The research therefore is a census survey of commercial banks in Kenya for the years 2009 to 2013. As already mentioned in the introduction the study provided two types of data analysis methods i.e. descriptive analysis and inferential analysis. In descriptive statistics mean, standard deviation, minimum and maximum of the study variables were determined. The study also carried out inferential statistics to determine casual relationships between variables i.e. correlation, regression and tested the analyzed the data for correlation using Pearson correlation coefficient.

4.3. Descriptive Statistics

The study analyzed the banks financial performance as measured by the return on assets ratio It also analyzed corporate board dynamics variables of interest namely; board size, board composition, gender diversity and the control variable of firm size as measured by total assets. Their mean, standard deviation, minimum and maximum values and total number of observations is presented in table 4.1.

Table 4.1: Summary Statistics

Variables	Mean	Std. Deviation	Median	Minimum	Maximum
Return on Assets	0.02	0.03	0.025	-0.19	0.10
Board Size	10	4	2.303	5	23
Board composition	3	1	0.250	1	10
Gender Diversity	1	1	0.091	0	6
Firm Size (Ksh Billion)	14,858	99,574	16,805	1,238	806,626

Source: Research Data 2014

The above table shows results of summary statistics of all variables in the data analysis It provides the information about the mean, dispersion and variability in the data. From the findings above the average return on assets for Kenyan banks is 2% with the highest return being 10% and the lowest being -1.9% during the period of the study. The average board size for the Kenyan commercial banks is 10 board members, The bank that had the highest board size had 23 members. The average number of executive board members

during the period of study was 3. The average women representation in the boards of commercial banks is 1 and the bank with the highest number of women board members was had 6.

The average asset base of the commercial banks in Kenya is Ksh 14.858 billion with the with the smallest asset base having Ksh 1.238 billion during the period of the study. The analysis also revealed that there exist a relationship between the asset size and financial performance of commercial banks. The lower that level of investment in assets the lower the returns. The bank that had the highest asset base of Ksh. 806,626 Billion had the highest return of 10% while the one that had the smallest asset base had the lowest returns of -19% which means that it made a loss.

4.4. Correlation Analysis

In this section the study measured the degree of association between selected corporate board dynamics namely: board size, board composition, gender diversity and the financial performance of the commercial banks in Kenya as measured by the return on assets. From the previous chapter the researcher hypothesized a positive relationship between the corporate board dynamics and the financial performance. A correlation analysis was performed to establish the relationship between the variables under study. Person correlation coefficients were established for all the variables. Table 4.2 presents correlation coefficients summary.

Table 4.2: Correlation Analysis

Variables	ROA	Board Size	Board Composition	Gender Diversity	Firm Size
Return on Assets	1				
Board Size	-0.052	1			
Board Composition	-0.111	0.036	1		
Gender Diversity	0.093	0.554	0.121	1	
Firm Size	0.293	0.310	0.006	0.126	1

Source: Research Data 2014

The study results indicate that there was moderate positive correlation between ROA and gender diversity (0.093) as well as the firm size (0.293). This indicates that an increase in the number of women in the board and increase in firm size would translate into a rise in ROA. The relationship between ROA and gender diversity as mentioned above was however very weak at 0.093.

The study results also shows that board size and the board composition of commercial banks were negatively correlated to ROA at (-0.052) and (-0.111) respectively. Although the relationship is weak it would indicate that an increase in executive board members would result in a reduction of ROA.

The results show little evidence on multi co-linearity among the exploratory variables since the correlations among them are not very strong hence all can be incorporated into subsequent regression analysis

4.5. Regression Analysis

The researcher conducted a multiple linear regression analysis so as to determine whether there exists a relationship between the selected corporate board dynamics and financial performance of commercial banks in Kenya for the period 2009-2013.

Table 4.3: Regression Statistics

Model	R	R Square	Adjusted R Square	Std. Error of Estimate
1	0.390	0.152	0.136	0.029

Source: Research Data 2014

According to Table 4.3, the r-squared for the regression model was 0.152. The model therefore is explaining 15.18% of the change in ROA using the four independent variables. These findings indicate that the independent variables selected (board size, board composition, gender diversity and control variable of firm size,) can only explain 15.18% of the change in ROA of the commercial banks in Kenya.

From this study, it is evident that at 95% confidence level the study variables produce statistically significant values and therefore can be relied on to explain Financial performance of the commercial banks in Kenya as measured by ROA.

Table 4.4: ANOVA

Model	Df	Sum of Squares	Mean Square	F	Sig. p-value
Regression	4	0.031	0.008	9.394	0.000
Residual	210	0.173	0.001		
Total	214	0.204			

Source: Research Data 2014

From table 4.4 - ANOVA at 5% significant level, the model is useful for predicting the response since; F-value =9.394 and the p-value is at 0.000 which is less than 0.05 Therefore; at $\alpha = 0.05$ level of significance, there exist enough evidence to conclude that at least one of the four predictor variables is useful for predicting ROA; Therefore the model is useful.

Table 4.5 gives the results of data fitted on the regression model, and it shows the coefficients returned by the model. Based on the p-values obtained all the four variables i.e. Board size, board composition, gender diversity and firm size are statistically significantly correlated with banks financial performance as measured by ROA when these are considered on an individual basis.

Table 4.5: Regression Coefficients

Independent Variables	Regression Coefficients	Standard Error	t Stat	P-value
Intercept	-0.008	0.020	-0.403	0.687
Board Size	-0.024	0.007	-3.462	0.001
Board composition	-0.048	0.024	-2.020	0.045
Gender Diversity	0.062	0.022	2.820	0.005
Firm Size	0.005	0.001	5.254	0.000

Source: Research Data 2014

The coefficients show the nature of relationship between individual model parameters (α and β) and the dependent variable Financial performance. From table 4.5 the nature of relationship between the financial performance of commercial banks in Kenya and the constant (α) was negative while the nature of relationship between financial performance and the coefficient of change (β_1) and (β_2) was also negative therefore a negative relationship. However, (β_3) has a positive coefficient and so is (β_4) thereby suggesting a positive relationship. This shows that as board size and board composition variables increased financial performance decreased but while gender diversity and firm size increased financial performance improved.

Using the regression equation model developed in the previous chapter:-

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

The regression model equation therefore becomes:-

$Y = -0.008 + -0.024\ X_1 + -0.048\ X_2 + 0.062\ X_3 + 0.005\ X_4$

Where:-

Y - Financial Performance measured by Return on Assets

X_1 - Board Size (Total Number of Board Members)

X_2 - Measure of board composition (Ratio of executive Board members over total number of board members)

X_3 - Measure of Gender Diversity of the Board (percentage of women in the board to total number of board members)

X_4 - Firm size, the total assets owned by the firm: Measured as the Natural Logarithm of total assets.

4.6. Discussion of Research Findings

The research sought to investigate the relationship between selected corporate board dynamics namely board size, board composition and gender diversity, a control variable of asset size was also incorporated. The research which was a census survey of the 43 commercial banks in Kenya collected and analyzed secondary data for the years 2009 to 2013. Return on Assets which is an accounting measure of financial performance based on historical data was used. Descriptive statistics, correlation analysis and regression analysis was performed to establish the relationship between the variables under study.

The results indicate that the Kenyan commercial bank industry is characterized by the following descriptive variables; the average return on assets is 2, the average board size

10 board members, the average number of executive board members during the period of study was 3, the average women representation in the boards is 1 member and the average asset base of the commercial banks in Kenya is Ksh 14.858 billion during the period of the study.

The study results indicate that there were moderate positive correlation between banks financial performance and gender diversity (0.093) and the firm size (0.293). This indicates that a rise in the number of women in the board and increase in firm size would result in a rise in ROA. The relationship between ROA and gender diversity was however very weak and therefore statistically insignificant. The study results also shows that board size and board composition of commercial banks were negatively correlated to ROA at (-0.05) and (-0.110) respectively. Although the relationship is statistically weak, it would indicate that an increase of executive members in the board would result in a reduction of ROA. It means that as the number of board members increase it would lead to a reduction of the bank's financial performance.

From the results, the p-values for the two variables: board size and the control variable Asset size are 0.000 at the 95% significance level, This indicates that the correlation between firm size and board size is highly significant. Board composition and gender diversity are also moderately significant variables in firm performance model represented by Return on Assets based on their p-values obtained. These results seem to give weight on the agency theory when ROA is the performance indicator. However, the corporate

board dynamics studied only explains 15.18% of the change in ROA of the commercial banks in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1. Introduction

This chapter summarizes the study and makes conclusions based on the results obtained from the data analysis. The implications from the findings and areas for further research are also presented. This section also presents findings from the study in comparison with the findings of other scholars as presented in the literature review.

5.2. Summary of Findings

The study sought to empirically test the relationship of various board composition variables on the financial performance of commercial banks in Kenya. The sudy found that the overall regression model for firm performance based on return on assets is significant. This means that the independent variables of board size, board composition and gender diversity are important predictors of firm performance when firm size was incorporated as a control variable.

Stewardship theory roots for larger boards since it provides access to a range of resource. Furthermore, it is acknowledged that board size and Firm size are correlated (Dalton et al 1999).The study also found that there is a positive correlation between the board size and the firm size. Stewardship theorists also argue that senior executives will not disadvantage shareholders for fear of jeopardizing their reputation (Donaldson and Davis, 1994). Proponents of stewardship theory argue that the board should have a significant

proportion of inside directors to ensure more effective and efficient decision making. However, this study found a negative correlation between inside/executive directors and the banks financial performance.

5.3. Conclusions

The study found a strong correlation between board size and firm size. Large commercial banks therefore tend to have large size boards while smaller banks tend to have smaller boards. The average size of the board membership in Kenyan banks was found to be 10 board members. The variables with the highest correlation were board size and gender diversity. This means that as the board membership increase so does the female board members this appears to contradict a study conducted by Ekadah and Mboya (2012) which found a negative relationship. The average female board member membership in Kenyan commercial banks was found to be 1 within the five years studied.

Generally, greater female representation on boards not only increases the size of the human capital pool from which directors can be drawn, but also provides some additional skills and perspectives that may not be possible with all-male boards. This finding is consistent with the findings of Wetukha (2013) who found an average gender representation of 1% which was positively correlated to the financial performance of listed firms in Kenya's Nairobi Securities Exchange.

According to the study findings the selected corporate board dynamics investigated namely; board size, board composition and gender diversity although found to be

significant predictors of banks financial performance they only explain 15% of the overall banks financial performance.

5.4. Recommendations

The study focused on the relationship between selected board dynamics and the financial performance of commercial banks in Kenya. The study found that there is a strong negative correlation between board composition and financial performance. This means that the more executive board members are in the board the poorer the financial performance of a bank. This seems to contradict the stewardship theory and reinforces the agency theory. This contradiction between different theories needs to be established to guide in policy making on corporate governance issues. However the shareholders policy makers should focus on ensuring that they don't focus more on the executive managers sitting in the boards as there is no value addition according to this study.

The study results confirm that there is no significant positive relationship between board gender diversity among directors and firm performance, implying that role gender diversity adds little potential economic value to commercial banks in Kenya. However, board memberships of the banks should therefore attempt to incorporate more women members as it was proved to translate to more returns. The study also found that there is a negative correlation between the board size and the financial performance. This means that for banks to be steered to the path of good financial performance board members need to be reduced to an optimum level to ensure that there is diversity of skills and at the same time avoiding bloated boardrooms.

The three independent variables were found to be significant predictors of the financial performance based on the research model. It's therefore important that the right mix of these variables be put in place in order to maximize financial performance of the commercial banks in Kenya.

5.5. Limitations of the Study

The main limitation of study is inability to include more corporate board dynamics. This study only covered selected board dynamics of commercial banks in Kenya. The study could have covered more board dynamics and even could be across all sectors so as to provide a more broad based analysis. However, resource constraints placed this limitation. Another major limitation of study was the unavailability of data both financial and on board dynamics. This was especially so for the unlisted commercial banks. The information relating to executive board members for some banks was not clear since it was not expressly stated in their annual reports. The use of regression analysis also means that there is an assumption of linearity with various models which may not be the case. Finally, resource constrains in terms of finances and other resources including time was also experienced by the researcher.

5.6. Suggestions for Further Research

This study generalized findings to banks and therefore commercial institutions operating in Kenya. This raises questions whether this can hold as only commercial banks were studied. Further studies therefore need to be carried out to specifically find out the nature

of relationship between corporate board dynamics as one of the aspects of good corporate governance and financial performance in each sector of the market. Furthermore only a few board dynamics were studied and therefore there is need for further studies to investigate the nature of relationship between the other board dynamics and the financial performance this includes board members skills and level of education, years of experience, individual competencies. This can also be extended to cover not only commercial banks but also other sectors of the economy.

Since this study only focused on financial performance, further research will be extremely beneficial in this area covering all attributes of board composition like the age of directors, duality tenure, or background of directors or duration of tenancy of the C.E.O among many others and other measures of performance which may either be qualitative or quantitative. These studies may also be extended to cover privately owned firms in Kenya or conducted on quoted companies. The studies can also be extended to cover more periods as the current study only covered a span of five years.

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APPENDIX 1
LIST OF COMMERCIAL BANKS IN KENYA

1. AFRICAN BANKING CORPORATION
2. BANK OF AFRICA (K) LTD.
3. BANK OF BARODA (K) LTD.
4. BANK OF INDIA
5. BARCLAYS BANK OF (K) LTD.
6. CFCS TANBIC BANK KENYA LTD.
7. CHASE BANK LTD.
8. CITI BANK
9. COMMERCIAL BANK OF AFRICA LTD.
10. CONSOLIDATED BANK OF (K) LTD.
11. CO-OP BANK OF (K) LTD.
12. CREDIT BANK LTD.
13. DEVELOPMENT BANK (K) LTD.
14. DIAMOND TRUST BANK LTD.
15. DUBAI BANK LTD.
16. ECOBANK LTD.
17. EQUATORAL COMMERCIAL BANK LTD.
18. EQUITY BANK LTD.
19. FAMILY BANK LTD.
20. FIDELITY COMMERCIAL BANK LTD.
21. FINA BANK LTD.
22. FIRST COMMUNITY BANK LTD.
23. GIRO COMMERCIAL BANK LTD.
24. GUARDIAN BANK LTD.
25. GULF AFRICAN BANK
26. HABIB BANK A.G. ZURICH
27. HABIB BANK LTD.
28. HOUSING FINANCE.
29. I&M BANK LTD.
30. IMPERIAL BANK LTD.
31. JAMII BORA BANK LTD.
32. KENYA COMMERCIAL BANK LTD.
33. K-REP BANK LTD.
34. MIDDLE EAST BANK (K) LTD.
35. NATIONAL BANK OF (K) LTD.
36. NIC BANK LTD.
37. ORIENTAL COMMERCIAL .BANK LTD.
38. PARAMAOUNT UNIVERSAL BANK LTD.
39. PRIME BANK LTD.

40. STANDARD CHARTERED BANK (K) LTD.
41. TRANS-NATIONAL BANK LTD.
42. UBA BANK
43. VICTORIA COMMERCIAL BANK LTD.

Source: (CBK, 2014)

APPENDIX 2
DATA COLLECTION SHEET

	AFRICAN BANKING CORPORATION	BANK OF AFRICA (K) LTD.	BANK OF BARODA (K) LTD.	BANK OF INDIA	BARCLAYS BANK OF (K) LTD.
Year 2009					
Net Income					
Total Assets					
Total Board Size (No.)					
Executive Board Members					
No. of Female Board Members					
Firm Size *ln* of TA					
Year 2010					
Net Income					
Total Assets					
Total Board Size (No.)					
Executive Board Members					
No. of Female Board Members					
Firm Size *ln* of TA					
Year 2011					
Net Income					
Total Assets					
Total Board Size (No.)					
Executive Board Members					
No. of Female Board Members					
Firm Size *ln* of TA					
Year 2012					
Net Income					
Total Assets					
Total Board Size (No.)					
Executive Board Members					

No. of Female Board Members					
Firm Size *ln* of TA					
Year 2013					
Net Income					
Total Assets					
Total Board Size (No.)					
Executive Board Members					
No. of Female Board Members					
Firm Size *ln* of TA					