RELATIONSHIP BETWEEN SELECTED ASPECTS OF CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

REHEMA ANYANGO ADHIAMBO
D61/73689/2012

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

NOVEMBER 2014
DECLARATION
This research report is my original work and has never been presented for an award of diploma or a degree in this or any other university.

Signature…………………………………………            Date………………………………
Rehema Anyango Adhiambo
D61/73689/2012

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

Signature…………………………………………            Date………………………………
Dr. Fredrick Ogilo
Senior Lecturer
Department of Finance and Accounting
School of Business
University of Nairobi
DEDICATION

I dedicate this research project to my family members, especially my father who supported me both financially and emotionally. He was my tower of strength and mentor, encouraging me to persevere when I did not have the faith in my abilities. I would also wish to dedicate this project to my beloved husband who has been a pillar and anchor of my strength. He provided the much needed support, encouragement and prayers, not forgetting my dear mother and children for the moral support. God bless them all.
ACKNOWLEDGEMENT

I give thanks to the almighty Father for guiding me throughout the research project and giving me hope when things seemed impossible. I acknowledge my supervisor Dr. Fredrick Ogilo for the guidance he gave me throughout this research project. This project could not have been completed on time without his help and support. He was always there even when the end seemed so far. He ensured a well-researched paper was finalized. In undertaking the research project I had the help of several dedicated persons whom I wish to acknowledge and am indebted to: my friends Jane, Leah and Job who guided, criticized, enthused and gave suggestions that supported the efforts to get this project completed.
ABSTRACT
The main objective of this study was to determine the relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya. Specifically, this study examined board size, board composition, board Education Level, and boards Compensation and how they affect the financial performance of commercial banks in Kenya. This study adopted a cross-sectional research design. The population of the study comprised of all the 43 commercial banks licensed by Central Bank of Kenya that were in operational between Jan 2009 and Dec 2013. Secondary data was obtained from the audited financial reports of the Central Bank of Kenya for the period from 2009 to 2013. A multiple regression model was adopted to determine the relationship between the two variables. The study used one measure of performance which was return on assets (ROA), as the dependent variable and four measures of governance, namely the board size, board composition, board Education Level, and boards Compensation, as the key independent variables. The main findings were that, a large board size tends to impact performance negatively while Board composition, board compensation and board educational level was found to positively affect financial performance of commercial banks in Kenya because they tend to enhance the performance of the banks. In conclusion Commercial banks operating in Kenya, like any other form of business organization, in today's dynamic financial landscape should focus on proper governance aspects and principles not only to boost and enhance their financial performances but also act as path for gaining a better public image, thus recognized by the society in which the bank operates as socially receptive commercial banks which may augment the bank operations and survival. The study therefore recommends that for commercial banks in Kenya to register high performance they need to check the size of their board of directors and also increase the number of independent directors.
# TABLE OF CONTENT

- DECLARATION ........................................................................................................... i
- DEDICATION ............................................................................................................. ii
- ACKNOWLEDGEMENT .............................................................................................. iii
- ABSTRACT .................................................................................................................. iv
- LIST OF ABBREVIATIONS ......................................................................................... viii
- LIST OF TABLES ......................................................................................................... ix

## CHAPTER ONE: INTRODUCTION .............................................................................. 1

1.1 Background of the study ....................................................................................... 1
   1.1.1 Corporate Governance .................................................................................. 2
   1.1.2 Financial Performance .................................................................................. 3
   1.1.3 Corporate Governance and Financial performance ...................................... 4
   1.1.4 Commercial Banks in Kenya ........................................................................ 6

1.2 Research Problem ................................................................................................. 7

1.3 Objective of the study ........................................................................................... 9

1.4 Value of the study ................................................................................................. 9

## CHAPTER TWO: LITERATURE REVIEW ................................................................ 10

2.1 Introduction ........................................................................................................... 10

2.2 Theoretical Review .............................................................................................. 10
   2.2.1 Agency Theory .......................................................................................... 10
   2.2.2 Stewardship Theory .................................................................................. 11
   2.2.3 Stakeholder Theory .................................................................................. 12
   2.2.4 Resource Dependency Theory .................................................................... 13
   2.2.5 Transaction Cost Theory ........................................................................... 13
   2.2.6 Political Theory ........................................................................................ 14

2.3 Determinants of Financial performance in commercial banks ......................... 14
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.4</td>
<td>Empirical review</td>
<td>16</td>
</tr>
<tr>
<td>2.5</td>
<td>Summary of literature review</td>
<td>18</td>
</tr>
<tr>
<td>3.0</td>
<td>CHAPTER THREE: RESEARCH METHODOLOGY</td>
<td>20</td>
</tr>
<tr>
<td>3.1</td>
<td>Introduction</td>
<td>20</td>
</tr>
<tr>
<td>3.2</td>
<td>Research Design</td>
<td>20</td>
</tr>
<tr>
<td>3.3</td>
<td>Population of the study</td>
<td>20</td>
</tr>
<tr>
<td>3.4</td>
<td>Data Collection</td>
<td>20</td>
</tr>
<tr>
<td>3.5</td>
<td>Data Analysis</td>
<td>21</td>
</tr>
<tr>
<td>3.5.1</td>
<td>Operationalization of the Variables</td>
<td>23</td>
</tr>
<tr>
<td>3.5.2</td>
<td>Concepts and measurements of variables in the study</td>
<td>23</td>
</tr>
<tr>
<td>4.0</td>
<td>CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION</td>
<td>24</td>
</tr>
<tr>
<td>4.1</td>
<td>Introduction</td>
<td>24</td>
</tr>
<tr>
<td>4.2</td>
<td>Descriptive Analysis</td>
<td>19</td>
</tr>
<tr>
<td>4.3</td>
<td>Correlation Analysis</td>
<td>26</td>
</tr>
<tr>
<td>4.4</td>
<td>Regression Analysis</td>
<td>27</td>
</tr>
<tr>
<td>4.5</td>
<td>Interpretations of Findings</td>
<td>29</td>
</tr>
<tr>
<td>5.0</td>
<td>CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATION</td>
<td>30</td>
</tr>
<tr>
<td>5.1</td>
<td>Introduction</td>
<td>31</td>
</tr>
<tr>
<td>5.2</td>
<td>Summary of Findings</td>
<td>31</td>
</tr>
<tr>
<td>5.2.1</td>
<td>Board size</td>
<td>31</td>
</tr>
<tr>
<td>5.2.2</td>
<td>Board Composition</td>
<td>31</td>
</tr>
<tr>
<td>5.2.3</td>
<td>Board Educational level</td>
<td>32</td>
</tr>
<tr>
<td>5.2.4</td>
<td>Board Compensation</td>
<td>32</td>
</tr>
<tr>
<td>5.3</td>
<td>Conclusion</td>
<td>32</td>
</tr>
<tr>
<td>5.4</td>
<td>Recommendations</td>
<td>34</td>
</tr>
</tbody>
</table>
5.5 Limitation of the study .............................................................................................................. 28
5.6 Suggestions for further studies ............................................................................................... 29

REFERENCES ...................................................................................................................... Error! Bookmark not defined.

APPENDICES ...................................................................................................................... 41

APPENDIX A: QUESTIONNAIRE .......................................................................................... 41
APPENDIX B .......................................................................................................................... 39
LIST OF ABBREVIATIONS

CBK       Central Bank of Kenya
CG          Corporate Governance
FP           Financial Performance
NSE        Nairobi Securities Exchange
CEO        Chief Executive Officer
ROA     Return on Assets
ROE        Return on Equity
CCG   Centre for corporate Governance
CMA        Capital Market Authority
AMT     African Microfinance Transparency
MFC    Mortgage Finance Companies
PSCGT  Private Sector Corporate Governance Trust
OECD   Organizations for Economic Co-operation and Development.
LIST OF TABLES

Table 3.3: Summary of measurements of variables
Table 4.3: Return on Assets (Net Income/Total Assets)
Table 4.4: Correlations coefficient
Table 4.5: Regression analysis on ROA
Table 4.6: ANOVAa
Table 4.7: Coefficient
CHAPTER ONE: INTRODUCTION

1.1 Background of the study

The concept of Corporate Governance is about putting in place the structure, processes and mechanisms that insure that the firm is being directed and managed in a way that enhances long term shareholder value through accountability of managers and enhancing firm performance. Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997). It also deals precisely with problems of conflict of interest, design ways to prevent corporate misconduct and aligns the interests of stakeholders using incentive mechanism. Corporate Governance is viewed as ethics and a moral duty of firms. A variety of Corporate Governance frameworks have been developed and adopted in different parts of the world. According to Mulili and Wong (2010) countries that followed civil law (such as France, Germany, Italy and Netherlands) developed corporate frameworks that focused on stakeholders. On the other hand, countries that had a tradition of common law developed frameworks that focused on shareholders returns or interests.

Jensen and Meckling (1976) acknowledge that the principal-agent theory which has also been adopted in this study is generally considered as the starting point for any debate on the issue of corporate governance. A number of corporate governance mechanisms have been proposed to ameliorate the principal-agent problem between managers and their shareholders. These governance mechanisms as identified in agency theory include board size, board composition, Chief Executive Officer pay performance sensitivity, directors’ ownership and shareholder right (Gomper, Ishii and Metrick, 2003). They further suggest that changing these governance
mechanisms would cause managers to better align their interests with that of the shareholders thereby resulting in higher firm value.

Kenya’s corporate governance system has highly been influenced by two factors: The relaxation of bank licensing rules of 1982 and by the privatization processes that peaked in the 1990s. This led to the growth of many banks that did not put into practice proper corporate governance resulting into poor governance and management culture in the industry CCG (2004). A case in point was it the year 1984 when the Rural Urban Credit Finance was placed in interim liquidation.

1.1.1 Corporate Governance

Corporate Governance is defined as the process and structure used to direct and manage business affairs of the Company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholder long term value while taking into account the interest of other stakeholders (CMA Act, 2002). Corporate Governance has become a topical issue because of its immense contribution to the economic growth and development of nations. The absence of good Corporate Governance is a major cause of failure of many well performing companies. The economic well-being of a nation is the reflection of the performance of its companies. Thus the low level of development of developing nations is attributed to the low level of good Corporate Governance.

Corporate governance is a crucial issue for the management of banks, which can be viewed from two dimensions. One is the transparency in the corporate function, thus protecting the investors’ interest (reference to agency problem), while the other is concerned with having a sound risk management system in place (special reference to banks) (Jensen and Meckling, 1976). In any organization, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the organization depends on the
underlying soundness of its individual components and the connections between them. According to Morck, Shleifer and Vishny (1989), among the main factors that support the stability of any country’s financial system include: good corporate governance; effective marketing discipline; strong prudential regulation and supervision; accurate and reliable accounting financial reporting systems; a sound disclosure regimes and an appropriate savings deposit protection system.

Corporate governance can be measured by using the board size, board composition, board educational level and board experience which can either negatively or positively affects cost and profit efficiency, while the impact of board composition on profit efficiency is non-linear. Introducing risk-taking as an interaction component of board size and composition does not affect the robustness of the results. This affects the financial performance directly or indirectly of an organization.

1.1.2 Financial Performance

Financial Performance may be defined as the reflection of the way in which the resources of a company (bank) are used in the form which enables it to achieve its objectives or measuring the results of a firm's policies and operations in monetary terms. According to Heremans (2007) financial performance is the employment of financial indicators to measure the extent of objective achievement, contribution to making available financial resources and support of the bank with investment opportunities. The objectives are those of financial performance rather than goals for investors, creditors, or others who use the information or goals for the economy or society as a whole.

The role of financial performance in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be. For
example, saving and investing in productive resources capital formation are generally considered to be prerequisite to increasing the standard of living in an economy. To the extent that financial performing provides information that helps identify relatively efficient and inefficient users of resources, aids in assessing relative returns and risks of investment opportunities, or otherwise assists in promoting efficient functioning of capital and other markets, it helps to create a favorable environment for capital formation decisions. However, investors, creditors, and others make those decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions.

Financial performance is studied and measured by different researchers (Shah et al., 2011; Matolcsy and Wright, 2011; Yasser et al., 2011) using different measures. Two widely recognized accounting ratios are employed as proxies for financial performance in the banking sector. Return on asset measures how much profit the bank assets can generate. This ratio is free from the effects of bias that can result from differences in capital structure amongst banks. Return on equity measures how much profit the bank can generate from shareholder investment. It is best use to compare companies in the same industry. Annual share price return is also employed to provide a non-accounting measure of bank performance. It reflects the overall market evaluation of each bank in a year.

### 1.1.3 Corporate Governance and Financial performance

Better corporate governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision-making. In expectation of such an improvement, the firm’s value may respond instantaneously to news indicating better corporate governance. However, quantitative evidence supporting the existence of a link between the quality of corporate governance and firm performance is relatively scanty (Imam, 2006). Good governance means little expropriation of corporate resources by managers or controlling
shareholders, which contributes to better allocation of resources and better performance. As investors and lenders will be more willing to put their money in firms with good governance, they will face lower costs of capital, which is another source of better firm performance. Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and long lasting than those with firms with less effective governance.

Implications for the economy as a whole are also obvious. Economic growth will be more sustainable, because the economy is less vulnerable to a systemic risk. With better protection of investors at the firm level, the capital market will also be boosted and become more developed, which is essential for sustained economic growth. At the same time, good corporate governance is critical for building a just and corruption-free society. Poor corporate governance in big businesses is fertile soil for corruption and corruptive symbiosis between business and political circles. Less expropriation of minority shareholders and fewer corruptive links between big businesses and political power may result in a more favorable business environment for smaller enterprises and more equitable income distribution (Iskander and Chamlou, 2000).

On a theoretical perspective, corporate governance has been seen as an economic discipline, which examines how to achieve an increase in the effectiveness of certain corporations with the help of organizational arrangements, contracts, regulations and business legislation. It is not a disputed fact that banks are crucial element to any economy; this therefore demands that they have strong and good corporate governance if their positive effects were to be achieved (Basel Committee on Banking Supervision, 2003).

In Kenya, financial reforms have encouraged foreign banks to enter and expand banking operations in the country. Kamau (2009) affirm that foreign banks are more efficient than local
banks. She attributes this to the fact that foreign banks concentrate mainly in major towns and target corporate customers, whereas large local banks spread their activities more widely across the country. Foreign banks therefore refrain from retail banking to specialize in corporate products, while large domestic banks are less discriminatory in their business strategy, (Njoka, 2010). These different operational modalities affect efficiency and profitability she notes.

1.1.4 Commercial Banks in Kenya
In Kenya, the Banking Sector is composed of the Central Bank of Kenya, as the regulatory authority and the regulated; Commercial Banks, Non-Bank Financial Institution and Forex Bureaus. As at 31st December 2009 the banking sector comprised 45 institutions, regulated under the banking Act, Cap 488 and Prudential Regulations issued there under. Forex Exchange Bureaus are licensed and regulated under the Central Bank of Kenya (CBK) Act, Cap 491. Out of the 45 commercial banking institutions, 33 were locally owned and 12 were foreign owned. Performance of the banking sector was rated strong as institutions achieved satisfactory conditions and improve operations results despite high market completion as each of these institutions scramble for a significant market share. New products have been introduced in the market as a result of rising completion.

Matama (2006) argue that commercial banks pose unique corporate governance problems for managers and regulators, as well as investors and depositors. They observe that the intellectual debate in corporate governance has focused on two different issues which should focus exclusively on protecting the interests of equity claimants in the corporation or whether corporate governance instead expand its focus to deal with problems of other groups stakeholders or non-stakeholder constituencies. Corporate governance should concern itself
exclusively with the challenge of protecting equity claimants and attempts to specify ways in which the corporation can better safeguard those interests.

According to Central Bank of Kenya (2002), corporate governance in the banking sector largely relates to the responsibility conferred to and discharged by the various entities and persons responsible for and concerned with the prudent management of the financial sector. The corporate governance stakeholders in the banking sector include the following: The board of directors, the management, the shareholders, Central Bank of Kenya, external auditors and Capital markets Authority.

1.2 Research Problem

Corporate governance has been found to be strongly positively correlated with financial performance, implying that poor corporate governance practices are associated with poor financial performance, and vice versa. This agrees with the statements of the researchers; Coleman and Osei (2007), Dittmar and Mahrt-Smith (2007) that corporate governance has been identified to have a significant impact on the performance.

Measures have been put in place by institutions such as Central Bank of Kenya, Capital Markets Authority and Centre for Corporate Governance to champion the cause of good corporate governance. Regardless of efforts made to streamline the banking sector, many banks have been liquidated or put under receivership. The collapse was due to weak internal controls, conflict of interest, insider lending, poor governance and management practices. For example, Euro Bank collapsed in 2003 and Daima Bank Ltd in 2005. Despite tight regulatory framework, Corporate Governance continues to weaken in Kenya.
Locally, Mang’unyi (2011) carried out a study to explore the ownership structure and Corporate Governance and its effects on performance of firms. His study focused on selected banks in Kenya. His study revealed that there was significant different between Corporate Governance and financial performance of banks. The study recommended that corporate entities should promote Corporate Governance to send positive signals to potential investors and those regulatory agencies including the government should promote and socialize Corporate Governance and its relationship to firm performance across industries. Miring’u and Muoria (2011) analyzed the effects of Corporate Governance on performance of commercial state corporations in Kenya. Using a descriptive study design, the study sampled 30 SCs out of 41 state corporations in Kenya and studied the relationship between financial performance, board composition and size. The study found a positive relationship between Return on Equity (ROE) and board compositions of all State Corporations. Wanjiku et al. (2011) carried out a study to establish the Corporate Governance practices of firms and its relationship with the growth of Companies listed at the Nairobi Securities Exchange using a causal comparative research design. The study focused on corporate communication, leadership and technology application. The study found a positive linear dependence of growth and Corporate Governance.

None of these studies have focused on the relationship between selected aspects of Corporate Governance and financial performance of commercial banks in Kenya. The researchers have examined the relationship between variety of governance mechanisms and firm performance. However, the results are mixed. Some researchers examine only one governance mechanism on performance while others investigate the influence of several mechanisms on performance. This has invariably led to limitations in the depth of our understanding of corporate governance issues. The study sought to answer the following question; what is the relationship between
selected aspects of corporate governance and financial performance in the commercial banks in Kenya?

1.3 Objective of the study
To determine the relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya.

1.4 Value of the study
Financial managers will be more sensitive to the influence that the various owners may have to the decisions they make with regard to the various corporate decisions such as dividend policy, investment policy and capital budgeting decisions of banks. Financial Managers will further identify whether minority investors have a role to play. Many Commercial Banks in Kenya will find the study very valuable to their operations and more so a benchmark to decisions to improve on corporate governance in the banking industry.

To theory, the study will be useful to scholars and academic researchers understand more of the information on relationship between corporate governance and financial performance of commercial banks hence adding more information to the existing of pool of knowledge. It will also be used as a basis for further research.

Policy makers will pursue economic reforms that will influence the corporate policies to be geared towards the welfare of the nation at large and protection against minority investors. This study will also guide policy makers in the banking sector especially the Central Bank of Kenya and the treasury in coming up with policies which will spur growth and profitability in this sector.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviewed various theories that provide explanations to the relationship between selected aspects of corporate governance and the financial performance. The theories discussed are agency theory, Stewardship theory, stakeholder’s theory, resource dependency theory, transaction cost theory and political theory. It further examined the previous empirical research done in the area of study, followed by the explanations of variables in the analysis model before the concluding remarks.

2.2 Theoretical Review

Various theoretical frameworks have been researched to find out whether there was a relationship between corporate governance and financial performance of a firm and to examine their effect on the financial performance of such firms.

2.2.1 Agency Theory

According to Jensen and Meckling (1976) agency theory suggests that the firm can be viewed as a nexus of contracts between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents (Clarke, 2004). The primary agency relationships in business are those between stockholders and managers; and between debt holders and stockholders. These relationships are not necessarily harmonious; agency theory is concerned with agency conflicts, or conflicts of interest between agents and principals. This has implications for, among other things, corporate governance and business
ethics (Padilla, 2000). When agency occurs it also tends to give rise to agency costs, which are expenses incurred in order to sustain an effective agency relationship.

Agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can be applied to align the goals of the management with that of the owners. The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976).

2.2.2 Stewardship Theory

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

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

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al. (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science. Stakeholder theory can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve this include the suppliers, employees and business partners, and it was argued that this group of network is important other than owner-manager employee relationship as in agency theory (Freeman, 1999).

Jenson (2001) critique the Stakeholders theory for assuming a single-valued objective (gains that accrue to a firm’s constituencies). The argument of Jensen (2001) suggests that the performance of a firm is not and should not be measured only by gains to its stakeholders. Other key issues such as flow of information from senior management to lower ranks, inter-personal relations, working environment, etc are all critical issues that should be considered. Some of these other issues provided a platform for other arguments as discussed later. An extension of the theory called an enlightened stakeholder theory was proposed. However, problems relating to empirical testing of the extension have limited its relevance (Sanda et al., 2005).
2.2.4 Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold, (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Indeed, Johnson et al. (1996) concurs that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure. It has been argued that the provision of resources enhances organizational functioning, firm’s performance and its survival (Daily et al, 2003). According to Hillman, Canella and Paetzold (2000) that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy.

2.2.5 Transaction Cost Theory

Transaction cost theory was first initiated by Cyert and March (1963) and later theoretical described and exposed by (Williamson, 1996). Transaction cost theory was an interdisciplinary alliance of law, economics and organizations. Resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. The underlying assumption of transaction theory is that firms have become so large they in effect substitute for the market in determining the allocation of
resources. In other words, the organization and structure of a firm can determine price and production. The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms’ transactions to their interests (Williamson, 1996).

2.2.6 Political Theory

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1993). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments’ favour. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms’ mechanism (Hawley and William, 1996).

2.3 Determinants of Financial performance in commercial banks

The determinants of financial performances in the bank can be classified into bank specific (internal) and macroeconomic (external) factors (Al-Tamimi, 2010; Aburime, 2005). These are stochastic variables that determine the output. Internal factors are individual bank characteristics which affect the banks performance. These factors are basically influenced by internal decisions of management and the board. The external factors are sector-wide or country-wide factors which are beyond the control of the company and affect the profitability of banks. The overall financial performance of banks in Kenya in the last two decade has been improving. However, this doesn't mean that all banks are profitable, there are banks declaring losses (Oloo, 2010).
Capital adequacy is one of the bank specific factors that influence the level of bank profitability. Capital is the amount of own fund available to support the bank's business and act as a buffer in case of adverse situation (Athanasoglou et al., 2005). Banks capital creates liquidity for the bank due to the fact that deposits are most fragile and prone to bank runs. Moreover, greater bank capital reduces the chance of distress (Diamond, 2000). However, it is not without drawbacks that it induce weak demand for liability, the cheapest sources of fund Capital adequacy is the level of capital required by the banks to enable them withstand the risks such as credit, market and operational risks they are exposed to in order to absorb the potential loses and protect the bank's debtors.

The bank's asset quality is another bank specific variable that affects the profitability of a bank. The bank asset includes among others current asset, credit portfolio, fixed asset, and other investments. Often a growing asset (size) related to the age of the bank (Athanasoglou et al., 2005). More often than not the loan of a bank is the major asset that generates the major share of the banks income. Loan is the major asset of commercial banks from which they generate income. The quality of loan portfolio determines the profitability of banks. The loan portfolio quality has a direct bearing on bank profitability. The highest risk facing a bank is the losses derived from delinquent loans (Dang, 2011).

Management Efficiency is one of the key internal factors that determine the bank profitability. It is represented by different financial ratios like total asset growth, loan growth rate and earnings growth rate. Yet, it is one of the complexes subject to capture with financial ratios. Moreover, operational efficiency in managing the operating expenses is another dimension for management
quality. The performance of management is often expressed qualitatively through subjective evaluation of management systems, organizational discipline, control systems, quality of staff, and others. Yet, some financial ratios of the financial statements act as a proxy for management efficiency. The capability of the management to deploy its resources efficiently, income maximization, reducing operating costs can be measured by financial ratios. One of this ratios used to measure management quality is operating profit to income ratio (Ilhomovich, 2009; Sangmi and Nazir, 2010).

Liquidity is another factor that determines the level of bank performance. Liquidity refers to the ability of the bank to fulfill its obligations, mainly of depositors. According to Dang (2011) adequate level of liquidity is positively related with bank profitability. The most common financial ratios that reflect the liquidity position of a bank according to the above author are customer deposit to total asset and total loan to customer deposits.

2.4 Empirical review

Zheka (2007) studied the effect Corporate Governance on performance by constructing an overall index of Corporate Governance and shows that it predicts firm level productivity in Ukraine. The results imply that a one-point-increase in the index results in around 0.4%-1.9% increase in performance; and a worst to best change predicts a 40% increase in company’s performance.

Baker and Morey (2007) using a unique dataset from Alliance Bernstein, an international asset management company, with monthly firm-level and country-level governance ratings for 22 emerging markets countries over a five year period, report a significantly positive relation
between firm-level and country-level Corporate Governance ratings and market valuation, suggesting lower cost of equity for better governed firms.

Beiner, Drobetz, Schmid and Zimmerman, (2004) studied the Corporate Governance and firm valuation by using a broad Corporate Governance index and additional variables related to ownership structure, board characteristics, and leverage to provide a comprehensive description of firm-level Corporate Governance for a broad sample of Swiss firms. The study used Tobin’s Q for growth and found a positive relationship between Corporate Governance and growth. An increase in Corporate Governance index by one point caused an increase of the market capitalization by roughly 8.6%, on average, of a company’s book asset value.

Mang’unyi (2011) carried out a study to explore the ownership structure and Corporate Governance and its effects on performance of firms. His study focused on selected banks in Kenya. His study revealed that there was significant different between Corporate Governance and financial performance of banks. The study recommended that corporate entities should promote Corporate Governance to send positive signals to potential investors and those regulatory agencies including the government should promote and socialize Corporate Governance and its relationship to firm performance across industries.

Miring’u and Muoria (2011) analyzed the effects of Corporate Governance on performance of commercial state corporations in Kenya. Using a descriptive study design, the study sampled 30 SCs out of 41 state corporations in Kenya and studied the relationship between financial performance, board composition and size. The study found a positive relationship between Return on Equity (ROE) and board compositions of all State Corporations.
Wanjiku et al. (2011) carried out a study to establish the Corporate Governance practices of firms and its relationship with the growth of Companies listed at the Nairobi Securities Exchange using a causal comparative research design. The study focused on corporate communication, leadership and technology application. The study found a positive linear dependence of growth and Corporate Governance. Ongore and K’Obonyo (2011) conducted a similar study in Kenya to examine the interrelations among ownership, board and manager characteristics and firm performance in a sample of 54 firms listed at the Nairobi Securities Exchange. The findings from this study show a positive relationship between managerial discretion and performance.

Schmid (2004) studied the Corporate Governance and firm valuation by using a broad Corporate Governance index and additional variables related to ownership structure, board characteristics, and leverage to provide a comprehensive description of firm-level Corporate Governance for a broad sample of Swiss firms. The study used Tobin’s Q for growth and found a positive relationship between Corporate Governance and growth. An increase in Corporate Governance index by one point caused an increase of the market capitalization by roughly 8.6%, on average, of a company’s book asset value.

2.5 Summary of literature review

Corporate governance is a very vital issue for the management of banks in Kenya which can be viewed from two dimensions. One is the transparency in the corporate function, thus protecting the investors’ interest (reference to agency problem), while the other is concerned with having a sound risk management system in place (special reference to banks) the health of the organization depends on the underlying soundness of its individual components and the connections between them. Good corporate governance enhances effective marketing discipline,
strong prudential regulation and supervision, accurate and reliable accounting financial reporting systems, a sound disclosure regimes and an appropriate savings deposit protection system.

A responsible organization is rewarded by its good reputation. Numerous studies have been conducted based on this belief but have failed to arrive at the conclusion. As a result of this studies done show positive correlations, others negative and others no correlation at all and a closer examination of these studies reveals a number of concerns around data sources, the type and variety measures used as both independent and dependent variable. From the foregoing summary it emerges that the researchers have not been conclusive as regards to the relationship between selected aspects of corporate governance and the financial performance of commercial banks in Kenya, hence the study sort to fill this gap.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction
This chapter discussed the methodology that was employed in the research proposal. It details the research design, the population that was studied, the nature of the data collected and the data analysis technique employed.

3.2 Research Design
This study adopted a cross-sectional research design. This study therefore was able to generalize the findings to a larger population. The main focus of this study was quantitative. This research design was used to collect a snapshot of data and analysis of the relationships between study variables. The design was more appropriate as it enabled respondents to give their relevant information on the issue of interest to the study, (Cooper and Schindler, 2003).

3.3 Population of the study
Population of the study consisted of 43 licensed commercial banks in Kenya. The study used annual reports that were available. Data was obtained as from between Jan, 1st 2009 and Dec, 31st 2013 using Census survey.

3.4 Data Collection
Secondary data was used for this study. The secondary data was collected from the audited financial statements of commercial banks in Kenya, the Bank Supervision and Deposit Protection Fund Annual Reports of the Central Bank of Kenya. The relevant secondary data include board size, board composition, and board compensation other variables were, ROA pertaining to fiscal years 2009-2013.
3.5 Data Analysis

Data was edited, coded and classified into different components to facilitate a better and efficient analysis. The data collected was analyzed using regression and correlation analysis to establish whether there was a relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya. The Statistical Package for Social Sciences (SPSS) version 22 was used to analyze the data collected. The relationship was explained by the following regression model:
ROA = $\alpha_0 + \alpha_1 \text{BOS} + \alpha_2 \text{BODCOMP} + \alpha_3 \text{BOEDU} + \alpha_4 \text{BODCOM} + et$

Where:

ROA= Return on Assets

BOS = represents Board Size

BODCOMP=represents Board Composition

BOEDU=represents Board Education Level

BOEDUCOM=represents Boards Compensation

et= error term

$\alpha$=Constant

$\alpha_1$- constant (coefficient) of Board size

$\alpha_2$- a constant (coefficient) of Board Composition

$\alpha_3$- a constant (coefficient) of Board Education Level

$\alpha_4$- a constant (coefficient) of Boards Compensation
3.5.1 Operationalization of the Variables

Variables used in this empirical study include, dependent variable (firm’s performance) and independent variables. Concepts and measurements of these variables are summarized below.

3.5.2 Concepts and measurements of variables in the study

Table 3.3: Summary of measurements of variable

<table>
<thead>
<tr>
<th>Variable</th>
<th>Concepts</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>Return on asset</td>
<td>(Earnings Before Interest and Tax)/Total Assets</td>
</tr>
<tr>
<td>Board size</td>
<td>Board Members</td>
<td>Total number of directors on the board</td>
</tr>
<tr>
<td>Board Comp</td>
<td>Board Composition</td>
<td>Ratio of outside directors to total number of directors</td>
</tr>
<tr>
<td>Board Edu</td>
<td>Board’s Education level</td>
<td>Directors Educational background</td>
</tr>
<tr>
<td>BodCom</td>
<td>Board’ Compensation</td>
<td>Total reimbursements given back to the directors on the amount they have used.</td>
</tr>
</tbody>
</table>
CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

4.1 Introduction

This chapter discussed data analysis, findings, interpretations and presentation. Data for each variable was analyzed using correlation and thereafter, the regression analysis is tabulated and the findings discussed. The analysis was based on the data collected by use of questionnaires administered to CEOs of surveyed commercial banks and review of financial reports. The response rate was at 58.1% as out of the 43 banks which were surveyed, 25 responded as illustrated below in table 4.2.

Table 4.2 Number of banks surveyed

<table>
<thead>
<tr>
<th>Number of Banks Responded</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responded</td>
<td>25</td>
<td>58.1</td>
</tr>
<tr>
<td>Didn’t respond</td>
<td>18</td>
<td>41.9</td>
</tr>
<tr>
<td>Total</td>
<td>43</td>
<td>100%</td>
</tr>
</tbody>
</table>

4.2 Descriptive Analysis

The descriptive analysis results are shown in the table below. The ROA for each bank was computed and the results presented in Table 4.3 below. From this table it’s evident that ROA for banks in this sector fluctuates significantly ranging from as low as – 2% to a high of 27.6%. Barclays with an average ROA of 23.4% seems to be one of the best performers over the five year period while NIC Bank with an average ROA of 5.43% has the worst.
### Table 4.3 Return on Assets (Net Income/Total Assets)

<table>
<thead>
<tr>
<th>Bank</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 DTB</td>
<td>0.1495</td>
<td>0.1650</td>
<td>0.1402</td>
<td>0.1589</td>
<td>0.2253</td>
<td>0.1678</td>
</tr>
<tr>
<td>2 Chase Bank</td>
<td>0.1420</td>
<td>0.1379</td>
<td>0.1863</td>
<td>0.2033</td>
<td>0.1737</td>
<td>0.1686</td>
</tr>
<tr>
<td>3 Barclays</td>
<td>0.2420</td>
<td>0.2300</td>
<td>0.2403</td>
<td>0.2762</td>
<td>0.1813</td>
<td>0.2340</td>
</tr>
<tr>
<td>4 Equity</td>
<td>0.1169</td>
<td>0.0858</td>
<td>0.0921</td>
<td>0.0858</td>
<td>0.0834</td>
<td>0.0928</td>
</tr>
<tr>
<td>5 NIC</td>
<td>0.0359</td>
<td>0.0785</td>
<td>0.0333</td>
<td>0.0466</td>
<td>0.0773</td>
<td>0.0543</td>
</tr>
<tr>
<td>6 I &amp;M</td>
<td>0.0936</td>
<td>0.0793</td>
<td>0.0532</td>
<td>0.0649</td>
<td>0.0561</td>
<td>0.0694</td>
</tr>
<tr>
<td>7 KCB</td>
<td>0.1839</td>
<td>0.1209</td>
<td>0.2171</td>
<td>0.1591</td>
<td>0.1749</td>
<td>0.1712</td>
</tr>
<tr>
<td>8 Co-operative</td>
<td>0.0790</td>
<td>0.0645</td>
<td>0.0564</td>
<td>0.0686</td>
<td>0.0696</td>
<td>0.0696</td>
</tr>
<tr>
<td>9 Prime Bank</td>
<td>0.1300</td>
<td>0.1520</td>
<td>0.0835</td>
<td>0.0407</td>
<td>0.0630</td>
<td>0.0939</td>
</tr>
<tr>
<td>10 Standard/Charted</td>
<td>0.0855</td>
<td>-0.023</td>
<td>0.1522</td>
<td>0.0591</td>
<td>0.0415</td>
<td>0.0629</td>
</tr>
</tbody>
</table>

Source: Computations from raw data obtained from CBK
### Table 4.4: Correlation Coefficients

<table>
<thead>
<tr>
<th></th>
<th>Board Size</th>
<th>Board Composition</th>
<th>Board Education Level</th>
<th>Board Compensation</th>
<th>ROA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board size</strong></td>
<td>Pearson Correlation</td>
<td>.364</td>
<td>.034</td>
<td>.172</td>
<td>-.073</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.302</td>
<td>.926</td>
<td>.634</td>
<td>.842</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>Board composition</strong></td>
<td>Pearson Correlation</td>
<td>.842</td>
<td>.257</td>
<td>.461</td>
<td>1</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.842</td>
<td>.257</td>
<td>.461</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>Board Education Level</strong></td>
<td>Pearson Correlation</td>
<td>.276</td>
<td>.361</td>
<td>1</td>
<td>.264</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.305</td>
<td>.440</td>
<td>.461</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>Board Compensation</strong></td>
<td>Pearson Correlation</td>
<td>.264</td>
<td>.264</td>
<td>1</td>
<td>.264</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.305</td>
<td>.461</td>
<td>.461</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>ROA</strong></td>
<td>Pearson Correlation</td>
<td>.264</td>
<td>.264</td>
<td>1</td>
<td>.264</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.305</td>
<td>.461</td>
<td>.461</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
On the correlation of the study variables, Pearson Product Moment correlation was conducted. From the findings on the correlation analysis between Return On Assets and various CG aspects, the study found that there was positive correlation coefficient between Return On Assets and Board Composition as shown by correlation factor of 0.396, the study also found a positive correlation between ROA and Board Education level as shown by correlation coefficient of 0.276, association between ROA and Board Compensation was found to have positive relationship as shown by correlation coefficient of 0.264. However, ROA and Board Size were found to have negative correlation with a correlation coefficient of -0.073.

4.4 Regression Analysis

Table 4.5: Regression analysis on ROA

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.969a</td>
<td>.939</td>
<td>.921</td>
<td>0.1575</td>
</tr>
</tbody>
</table>

From the analysis in the above table, the value of adjusted R squared was 0.921, an indication that there was variation of 92.1% on the financial performance (ROA) of commercial banks due to changes in Board Size, Board Composition, Board Education level and Board Compensation at 95% confidence interval. This shows that 92.1% changes in financial performance of commercial banks could be accounted for by Board size, Board Composition, Board Education level and Board Compensation. The findings show that there was a strong positive relationship between the study variables as shown by 0.969.
From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.015 which shows that the data is ideal for making a conclusion on the population’s parameter as the value of significance (p-value) is less than 5%. The value calculated was greater than the critical value ($2.262 < 3.869$) an indication that Board size, Board Composition, Board Education level and Board Compensation were significantly influencing financial performance (ROA) of commercial banks in Kenya. The significance value was less than 0.05 an indication that the model was statistically significant.

From the data in the above table the established regression equation was

$$Y = 0.455 - 0.016 X_1 + 0.182 X_2 + 0.053 X_3 + 0.204 X_4$$
From the above regression equation it was revealed that a unit increase in board size would lead to decrease in financial performance (ROA) of banks by a factor of 0.016, unit increase in Board Composition would lead to increase in financial performance of banks by a factor of 0.182, a unit increase in Board Education level would lead to increase in financial performance of banks by a factor of 0.053 and unit increase in Board Compensation would lead to increase in financial performance of banks by a factor of 0.204. At 95% level of confidence, Board Composition had a 0.036 level of significance; Board Compensation, a 0.028 level of significance, Board Education level had a 0.025 level of significance while Board Size showed 0.009 level of significance hence the most significant factor is Board Size. Overall Board Size had the greatest effect on the financial performance of bank industry, followed by Board Education level, and then Board Compensation Leverage and Board Composition had the least effect to the financial performance of banks. All the variables were significant (p<0.05).

4.5 Interpretations of findings

ROA measures the financial performance in the banks and when it’s low, it signifies that the bank is not performing well and when it’s high, it shows that the bank is performing well in terms of profitability and productivity. This was shown in the computed results in table 4.3, which gives evidence that ROA for companies had fluctuated significantly ranging from as low as -2% for Standard Chartered Bank in 2010 to a high percentage of 27.6% for Barclays Bank in 2012.

In table 4.5, there was variation of 92.1% on the financial performance of commercial banks due to changes in board size, Board composition, Board educational level and board compensation at 95% confidence level. This shows that 92.1% changes in financial performance of commercial
banks could be accounted for by board size, Board composition, Board educational level and board compensation.

From the findings in table 4.6 the ANOVA statistics, shows that the population parameters had a significance level of 0.015 which shows that the data was ideal for making a conclusion as the value of significance (p-value) was less than 5%. The value computed was greater than the critical value(2.262<3.869) which indicated that Board size, Board Composition, Board Education level and Board Compensation were significantly influencing financial performance (ROA) of commercial banks in Kenya. The significance value was less than 0.05 an indication that the model was statistically significant.

Finally in table 4.7, the coefficients showed that at 95% level of confidence, Board Composition had a 0.036 level of significance; Board Compensation, a 0.028 level of significance, Board Education level had a 0.025 level of significance while Board Size showed 0.009 level of significance hence the most significant factor was Board Size. Overall Board Size had the greatest effect on the financial performance of bank industry, followed by Board Education level, and then Board Compensation Leverage and Board Composition had the least effect to the financial performance of banks. They were all significant (p<0.05).
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter presents a summary of findings to the study, and in the process, draws conclusions based on the finding of the study. The chapter subsequently, makes recommendations arising from the conclusions of the study. Finally the chapter makes suggestions for further research in connection with certain specific areas of this study.

5.2 Summary of Findings

The study used regression and correlation analysis to establish the relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya. One major finding of the study is that there is a strong relationship between the independent variables (board composition, board educational level and board compensation) used in the model and the dependent variable (ROA).

5.2.1 Board size

From the findings on the correlation analysis between Return on Assets and the board size, the study found a negative correlation with a correlation coefficient of -0.073 in table 4.4. From the regression equation in table 4.7, it was revealed that a unit increase in board size would lead to decrease in financial performance (ROA) of banks by a factor of 0.016. Board Size showed a 0.009 level of significance which was the most significant factor. Overall Board Size had the greatest effect on the financial performance of the commercial banks.

5.2.2 Board Composition

There was a positive correlation coefficient of 0.369 between Return on Assets and Board Composition as shown in table 4.4. Board Composition led to an increase in financial
performance of commercial banks by a factor of 0.182 in table 4.7. Board Composition had a 0.036 level of significance and had the least effect on the financial performance of commercial banks in table 4.7.

5.2.3 Board Educational level
The study also found a positive correlation between Return on Assets and the board educational level as shown by correlation coefficient of 0.276 in table 4.4. At 95% level of confidence, board educational level had a 0.025 level of significance while, Board educational level had the second greatest effect on the financial performance of commercial banks as shown in table 4.7. A unit increase in board educational level would lead to increase on financial performance of commercial banks by a factor of 1.483 as shown in table 4.4.

5.2.4 Board Compensation
The association between Return on Assets and board compensation was found to have positive relationship as shown by correlation coefficient of 0.264 in table 4.4. Board Compensation showed a 0.028 level of significance. The main objective was to establish whether there is a relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya.

5.3 Conclusion
The study thus concludes that there is a relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya. From the findings on the effects of Board Size on the financial performance of commercial banks, the study found that various aspects of board size affect the financial performance of commercial bank to a great extent. From the regression analysis, board size was found to negatively affect the financial performance of commercial banks.
On the effects of board composition on the financial performance of commercial banks, the study established that various aspects of composition of the board affect the financial performance to a great extent. The study thus concludes that composition of the board positively influence the financial performance of commercial banks to a great extent. From the findings on effects of board educational level on the financial performance of commercial banks, the study found that various aspect of board educational level positively influenced the financial performance commercial banks to great extent.

From the findings on effects of board compensation on the financial performance of commercial banks, the study established that board compensation of the firm positively influenced the financial performance of commercial banks. The study thus concludes that board compensation of the firm positively influenced the financial performance of commercial banks. The relevance of corporate governance cannot be over-emphasized since it constitutes the organizational climate for the internal activities of a company. Corporate governance brings new outlook and enhances a firm’s corporate competitiveness. The study examined the relationship between selected aspects of corporate governance on the performance of commercial banks in Kenya by using ROA based performance measures. Indeed, corporate governance plays a vital role in the success and prosperity of the banks and other business firms. The regression results show further that the direction and the extent of firm’s performance is dependent on the predictors being examined. Results show that board size, board composition, board educational level and board compensation enhance corporate performance and that when such factors are capitalized, it enhances banking performance.
The results of the study may be taken as a sign that good governance structure is important in the young and immature financial institutions as it has an effect on the institution performance. The observations of the study do not only aim at fine-tuning governance in Commercial banks in terms of policy direction, but equally important to ensure collapse of Commercial banks as a result of governance is forestalled so as not to dent the critical process of poverty reduction and development. The study therefore concludes that good corporate governance aspects are positively correlated to the financial performance of commercial banks in Kenya. These governance attributes are good predictor of financial performance and should not be considered in isolation.

5.4 Recommendations

The commercial banks should adopt smaller boards as they enhance banks performance indicating a negative relationship between board size and performance as the decision making process is very quick as no much free riding and loafing of members will exist. A size of about ten members which is in line with best corporate governance practice in other countries is recommended. In addition to maintaining a small but effective board, qualification of appointees must relate to the core activities of the business in which the bank is engaged in rather than based on political lineage. Boards with a large number of directors can be a disadvantage and expensive for the banks to maintain. Planning, work coordination, decision-making and holding regular meetings can be difficult with a large number of board members.

At least one third of independent directors are preferred in board, for effective working of board and for unbiased monitoring. Dependent directors are also important because they have insider knowledge of the organization which is not available to outside directors, but they can misuse this knowledge by transferring wealth of other stockholders to themselves. It was recommended
that dependent directors are also important because they have insider knowledge of the organization which is not available to outside directors, but they can misuse this knowledge by transferring wealth of other stockholders to themselves. A board composed of members who are not executives of a company, or shareholders, or blood relatives or in law of the family was recommend. The board was to be composed of members who have no ties to the bank in any way, therefore there is no or minimum chance of having a conflict of interest because independent directors have no material interests in a bank.

The commercial banks should require each board member to be fully equipped with management knowledge such as finance, accounting, marketing, information systems, legal issues and other related areas to the decision making process. This requirement implies that the quality of each board member will contribute significantly and positively to management decisions which are then translated into the banks performance.

The commercial banks should attach their financial benefits to compensation paid to a firm’s management. Once management behavior is unclear, compensation is a corporate governance mechanism to encourage management to run a bank in the interest of shareholders. This link will resolve an agency issue between management and shareholders and contribute positively to a bank’s performance.

5.5 Limitation of the study

One limitation that affected the results of the study was the availability of data. The study targeted thirty (43) commercial banks, apart from those banks which posted their annual reports, it was difficult in obtaining data from the others whose reports were not posted. As a result, it took longer time than expected to have the relevant data required for the analysis. This affected
the timeframe expected for the study to have been completed. The study population was twenty five banks drawn from the entire population of forty three banks and might not represent the majority of the financial institutions.

The study did not consider the quality of the board of directors to determine competence and experience in their oversight of the commercial banks in Kenya. This limitation may have probably generated other findings. Finally, findings generated as a result of the study are not in themselves all conclusive as the study focused only on four selected corporate governance aspects.

5.6 Suggestions for further studies

There is a need for further studies to be conducted separately on each commercial bank. That is, separate studies should be conducted exclusively on profit-oriented commercial banks. This will enable the government undertake a more comprehensive measure aimed at enhancing efficiency and productivity.

Second, the number of the independent variables (corporate governance aspects) needs to be increased as this study only explained 92.1% of variation in the ROA in the commercial banks in Kenya is attributable to the corporate governance aspects used in this study. The study only covered 43 commercial banks in the country. It would be prudent to cover at least all banks in future studies.

Finally, it would be more rewarding if further studies on corporate governance were to take on a more holistic approach to performance. This should include operational efficiency and other non-financial performance indicators.
REFFERENCES


Ilhomovich, S.E. (2009). *Factors affecting the performance of foreign banks in Malaysia.* A thesis submitted to the fulfillment of the requirements for the degree of Master of Science (Banking) College of Business (Finance and Banking.)


APPENDICES

APPENDIX A: QUESTIONNAIRE

This questionnaire will assist in gathering information about the relationship between selected aspects of corporate governance and financial performance of commercial banks in Kenya. All the information gathered will be treated with highest confidentiality and it will be appreciated.

Date: -----------------------------------
Name of Bank: ------------------------

SECTION A: BOARD SIZE (BODSIZE)

Indicate your level of agreement with the following statements by ticking at the appropriate box. Use the ratings criteria below.

*Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)*

<table>
<thead>
<tr>
<th>Questions</th>
<th>SA</th>
<th>A</th>
<th>U</th>
<th>D</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  Size of the board affects the financial performance of Commercial banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2  The board meets regularly during the year to review financial performance and operations of the bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3  The board considers strategic matters and other issues that impact on the bank’s performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4  Dialogue and meetings between the board and senior management is held outside formal board meetings.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5  Board members usually avail themselves to support Management on areas of their expertise.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6  The board is effective at monitoring senior management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7  The board undertakes self-evaluation and review of its performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### SECTION B: BOARD COMPOSITION (BODCOMP)

Indicate your level of agreement with the following statements by ticking at the appropriate box. Use the ratings criteria below.

*Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)*

<table>
<thead>
<tr>
<th>Questions</th>
<th>SA</th>
<th>A</th>
<th>U</th>
<th>D</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Board composition affect the financial performance of a firm</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Board composition affects the way the board communicates with other stakeholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 The number of non-executive directors on the board affect the performance of the commercial banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Outside directors are better able to challenge and discipline the management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Boards composed of directors with good mix of skills, experience and competences can take the business to greater heights</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 The board should be responsible for selecting top management staff</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Boards perform better where expatriates sit on them</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 The work of the board includes active monitoring of the activities of management and resolution of internal conflicts.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 An expatriate board member has superior knowledge and is likely to improve the performance of commercial banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SECTION C: BOARD EDUCATION LEVEL (BODEDU)

Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

*Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)*

<table>
<thead>
<tr>
<th>Questions</th>
<th>SA</th>
<th>A</th>
<th>U</th>
<th>D</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  Board education level affect the financial performance of a bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2  Board education level affect the decision making in the banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3  Each position in the bank should be determined by the level of education attained</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4  A board of directors supervising management decisions in an efficient manner will improve firm’s performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5  Board member should be fully equipped with management knowledge such as finance, accounting, marketing, information systems, legal issues and other related areas to the decision making process.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6  This requirement implies that the quality of each board member will contribute significantly and positively to management decisions.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SECTION D: BOARD COMPENSATION (BODCM)
Indicate your level of agreement with the following statements by ticking at the appropriate box.
Use the ratings criteria below.
*Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)*

<table>
<thead>
<tr>
<th>Questions</th>
<th>SA</th>
<th>A</th>
<th>U</th>
<th>D</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Board compensation affect the financial performance of a bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 The compensation will provide a better link between shareholders and firm’s management and this link will enhance firm’s performance to maximize shareholders’ value.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Board’s compensation has positive correlations with bank’s performance.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Board compensation is a corporate governance mechanism to encourage management to run a firm in the interest of shareholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Board compensation contribute positively to a firm’s performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SECTION E: BANK FINANCIAL PERFORMANCE

Indicate your level of agreement with the following statements by ticking at the appropriate box. Use the ratings criteria below.

*Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)*

<table>
<thead>
<tr>
<th>Questions</th>
<th>SA</th>
<th>A</th>
<th>U</th>
<th>D</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The bank has had good improvement on return on assets in the last three years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Financial performance will always depend on the board size, board composition, board educational level and board compensation.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Good corporate governance will always affect the bank financial performance.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. The role of financial performance in the economy is to provide information that is useful in making business and economic decisions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX B
Licensed Commercial Banks in Kenya as at 2013

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank (Kenya)
6. CFC Stanbic Bank
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Eco bank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. First Community Bank
22. Giro Commercial Bank
23. Guaranty Trust Bank
<table>
<thead>
<tr>
<th></th>
<th>Bank Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>24.</td>
<td>Guardian Bank</td>
</tr>
<tr>
<td>25.</td>
<td>Gulf African Bank</td>
</tr>
<tr>
<td>26.</td>
<td>Habib Bank</td>
</tr>
<tr>
<td>27.</td>
<td>Habib Bank AG Zurich</td>
</tr>
<tr>
<td>28.</td>
<td>Housing Finance corporation bank</td>
</tr>
<tr>
<td>29.</td>
<td>I&amp;M Bank</td>
</tr>
<tr>
<td>30.</td>
<td>Imperial Bank Kenya</td>
</tr>
<tr>
<td>31.</td>
<td>Jamii Bora Bank</td>
</tr>
<tr>
<td>32.</td>
<td>Kenya Commercial Bank</td>
</tr>
<tr>
<td>33.</td>
<td>K-Rep Bank</td>
</tr>
<tr>
<td>34.</td>
<td>Middle East Bank Kenya</td>
</tr>
<tr>
<td>35.</td>
<td>National Bank of Kenya</td>
</tr>
<tr>
<td>36.</td>
<td>NIC Bank</td>
</tr>
<tr>
<td>37.</td>
<td>Oriental Commercial Bank</td>
</tr>
<tr>
<td>38.</td>
<td>Paramount Universal Bank</td>
</tr>
<tr>
<td>39.</td>
<td>Prime Bank (Kenya)</td>
</tr>
<tr>
<td>40.</td>
<td>Standard Chartered Kenya</td>
</tr>
<tr>
<td>41.</td>
<td>Trans National Bank Kenya</td>
</tr>
<tr>
<td>42.</td>
<td>United Bank for Africa</td>
</tr>
<tr>
<td>43.</td>
<td>Victoria Commercial Bank</td>
</tr>
</tbody>
</table>