THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF MICROFINANCE BANKS IN KENYA

BY

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DECLARATION

I hereby declare that this research project is my original work and has not presented in any other institution.

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This research proposal has been submitted for presentation with my approval as the university supervisor.

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DEDICATION

This research paper is also dedicated to my beloved mother Pamella, my sister Riziki for the invaluable support, encouragement and also for the motivation to further my academic level.

I am immensely grateful and may our good Lord bless you always and forever.

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ABBREVIATIONS AND ACRONYMNS

ACCA - Association of Certified Chartered Accountants

AMFI - Association of Microfinance Institutions

BDG - Board Gender Diversity

BDI -Board Independence

BDS -Board Size

CBK -Central Bank of Kenya

CEO - Chief Executive Officer

CGAP - Consultative Group against the Poor

CM ACT - Capital Markets Act

GDP - Gross Domestic Product

MFBs - Micro-finance Banks

MFIs -Micro-finance Institutions

NEDs - Non Executive Board Members

NGOs - Non Governmental Organizations

OSS - Operational Self- Sustainability

ROA -Return on Assets

SACCOs - Savings and Credit Cooperatives

ABSTRACT

The study examined the effect of corporate governance practices on the financial performance of microfinance banks in Kenya. The corporate governance practices discussed include the proportion of non-executive directors, board size and board gender diversity. Firm size was used as the control variable. The study was based on a descriptive cross-sectional research design. The data gathered was from secondary sources. A multiple linear regression model was used to establish the relationship between the independent and dependent variables. ANOVA analysis was also used to test the overall significance of the model. The study found that board size had a positive significant effect on ROA while proportion of NEDs had a positive insignificant effect on financial performance as measured by ROA. This can be explained by the fact that firms with higher proportions of NEDs are more likely to experience insignificant financial performance improvement because NEDs are commonly part-time workers; this will undermine their ability to monitor and advise the board because of the lack of information which reduces the NEDs' ability to apply their function efficiently. Aside gender diversity showed a negative significant effect on the financial performance. The relationship between ROA and board gender diversity may be due to tokenism that suggests that forcing female director appointment or mandating gender quotas can reduce financial performance in MFBs with strong cultural resistance. This may also be explained by the fact that the positive effects of gender diversity may diminish in MFBs with higher female economic participation and empowerment. The trend in ROA and growth in total assets shows that there has been a tremendous improvement in the financial performance of MFBs. These results can be attributed to the adoption and implementation of corporate governance practices. Therefore it can be concluded that corporate governance has a significant effect on the financial performance of microfinance banks in Kenya as presented by a strong correlation coefficient of 57.9% and a p value of 0.0001 for the overall model. The results of the study show that good corporate governance practices enhance financial performance. Finally, CBK through their prudential regulations should ensure that the corporate governance disclosures in the annual reports are not simply statement of good intentions but are actually implemented at firm level. This will greatly improve the level of corporate governance adoption, implementation and by extension financial performance.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Microfinance is high on the public agenda and good corporate governance practices have been identified as key factors for enhancing the viability of the industry. The development enhancing aspect of micro-finance has been recognized with the Nobel Peace Prize awarded to Mohammad Yunus and Grameen Bank in 2006. Micro-finance is the provision of financial and non-financial services to the poor who are excluded from financial or credit markets because they are considered risky. The fundamental purpose of MFBs is to contribute to a country's development. This involves reaching out to more clients, especially the poor (Helms, 2006; Johnson et al., 2006). A typical characteristic of an MFB is its dual mission to serve the poor and remain financially sustainable. While the social goals of reaching the poorest and alleviating poverty are valid, financial sustainability has emerged as one of the core management and governance issues.

Sustainability of MFBs will focus on good governance structures within the industry. Corporate governance is the system of principles, policies, procedures, and clearly defined responsibilities and accountabilities used by stakeholders in managing and directing an organization. Corporate governance affects the operational risk and hence sustainability of MFBs. Governance is about achieving MFB goals. Mwasi (2011) assessed corporate governance practices adopted by MFIs in Kenya. The study established that MFIs (both for profit and not for profit) have large boards and that there were no challenges among the MFIs that were targeted in regard to adoption of CG practices; this is a good indication that MFIs in Kenya are on track with regards to

implementation of corporate governance practices. However, concern still remains on how these corporate governance practices have improved financial performance of MFBs.

A widely used framework to conceptualize the relationship between financial performance and organizational structure is agency theory, which was described by Denis and McConnell (2003) in terms of being an expression of property rights in corporate governance by principals; any understanding of firm structure must start with the proviso that shareholders are the principals (i.e. owners) in the organization. This study employs the agency theory as the main theory to investigate the relationship between corporate governance and financial performance. The agency theory deals with the interests of the shareholders with relation to the agency problem and the underlying target of value maximization. On the most basic level, reduced agency problems contribute to increasing share value and thus positive performance. Therefore, agency theory provides a direct link between corporate governance and financial performance.

1.1.1 Corporate Governance

Corporate governance is the process and structure used to direct and manage business affairs of the company. CG seeks to enhance prosperity and corporate accountability with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders (CM ACT 485A). Cadbury Committee (1992) (as cited in Alexandra, Lajoux & Reed, 2005) defines corporate governance as the system by which companies are directed and controlled. The nature of corporate governance, therefore, going by this definition consists of two dimensions; direction and control. The direction side of corporate governance emphasizes the responsibility of the board to attend to strategic positioning and planning in order to enhance

the performance and sustainability of the company. The control side of the definition emphasizes on the responsibility of the board to oversee the executive management of the company in the execution of plans and strategies.

According to Keasey et al. (1997), the most important features of an effective governance framework are ownership structure (institutional and managerial ownership), CEO (manager) and director (board member) remuneration, board structure, size, composition and independence, committees, independent audit, information disclosure and the market for corporate control. Bebchuk, Cohen and Ferrell (2004) identified the main characteristic of corporate governance as; board size, board composition and CEO duality. Audit Commission Report (2003) uses objective measurable factors such as director independence, structure of board committees and auditor independence, which they describe as "hard measures". The report distinguishes these from "soft measures" such as ethical and corporate culture and skills of directors. Heracleous (2001) argues that it could be impossible to measure soft governance attributes.

From the above studies, the main corporate governance practices could be summarized to be: Board structure which encompasses two-tier or single-tier board, presence of board committees and their structure; board composition which entails board size, gender diversity, professional diversity & educational level, outsider representation and tenure; board processes which consist of board role, involvement and board meetings; independence of board which is defined by the two-tier or single tier structure, outsider representation or non-executive board members; Auditing; Information disclosure.

1.1.2 Financial Performance

Performance refers to the extent to which organization's goals and objectives are achieved efficiently and effectively (Wanjau, 2007). Financial performance is an indicator of how profitable a company is relative to its total assets. There has been a wide variety of definitions of financial performance that have been proposed in the literature. Performance is the ability to sustain income stability and growth. Hassan et al. (2011) identified two broad categories of financial performance measures; investor returns and accounting returns. The basic idea of investor returns is that the return should be measured from the perspective of shareholders. Whereas accounting returns measures of financial performance focus on how firm earnings respond to different managerial policies. Accounting-based performance measures are; return on assets (ROA), total assets, sales growth, asset growth and operating income growth. Investment based returns measures are dividend yield, price earnings ratio among others. Ngatia (2012) identified firm size, return on assets (ROA), return on equity (ROE), asset age, and return on sales as the frequently used financial performance measures. Wanjau (2007) identified four indicators namely; market share, turnover or disbursement, portfolio quality and profitability as measures of microfinance performance.

Particularly, ROA is consistently claimed to be an authentic measure of Financial Performance (Berman et al., 1999). Unlike other accounting measures such as return on equity or return on sales, ROA is not affected by the differential degree of leverage present in firms. Because ROA is positively correlated with the stock price, a higher ROA implies higher value creation for shareholders. The ROA measures not only profit aspect but also those related to assets employed

to generate the profit. USAID Microenterprise Development Office in its, "Financial Reporting Standards" recommends the use of ROA and ROE as measures of MFI profitability.

1.1.3 Relationship between Corporate Governance and Financial Performance

Corporate governance is sometimes viewed as a business culture fostering economic growth by building up confidence of investors (The HIH Royal Commission Report, 2003). There have been mixed results concerning the association between corporate governance and financial performance. For instance, Klapper and Love (2004) found a high positive association between better governance and operating performance using firm level data of 14 emerging stock markets with return on assets as a proxy for operating performance, although affirming that this may vary among countries. Likewise, some other researchers (Brown & Caylor, 2004; Beiner et al., 2004; Gompers et al., 2001) reported a positive relationship between the quality of CG and their measures of profitability. Also, there is international evidence linking these positive relationships to certain developed markets. For instance, Selvaggi and Upton (2008) claimed that good CG enhances financial performance for the United Kingdom firms and found the presence of a strong correlation between the two variables. Similarly, Black (2001) reported the same conclusions in the case of Russian firms.

In contrast, other studies reported no significant positive relationship between financial performance and CG. For instance, Bauer et al. (2004) argued that initially an insignificant relationship was reported which afterwards turned to a significantly and statistically negative relationship. A similar outcome was also observed by Beiner et al. (2004). Moreover, other

studies (Park & Shin, 2004; Prevost et al., 2002) did not found any evidence of any relationship between the two variables.

1.1.4 Micro-finance Banks in Kenya

Micro-finance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises. There are four types of MFIs: formal institutions such as micro-finance banks, non-government organizations, cooperative organizations and informal sources such as money lenders and shopkeepers.

Microfinance industry in Kenya is under the umbrella of Association of Microfinance Institutions of Kenya (AMFI) Kenya. The Association is a member's institution that was registered in 1999 under the societies Act by the leading microfinance institutions in Kenya to build capacity of the micro-finance industry. AMFI presently has 62 member institutions serving more than 6,500,000 poor and middle class families with financial services throughout the country. 12 of these member institutions are registered as MFBs. The main objective of AMFI is provision of general policy guidelines and ensuring adherence to ethical practices and direction issued by the association (AMFI, 2013). The Microfinance Act authorizes the Central Bank of Kenya to license, regulate, and supervise the activities of formally constituted deposit-taking microfinance institutions in Kenya. The Act itself simply empowers the Central Bank as regulator, but specific rules subsequently released by the bank serve to govern micro-finance activity. In particular, the Bank has imposed core capital requirements designed to ensure adequate liquidity of depository MFBs and established minimum corporate governance standards and ownership limits (AMFI, 2013).

According to AMFI (2013) the number of microfinance banks in operation increased from 6 in 2012 to 12 in 2013. MFBs had gross loans worth Ksh 22.5 billion compared to Ksh 17.9 billion registered in 2012 thus translating to a growth of 25.7 percent. The deposits base stood at Ksh 19.7 billion representing a growth of 60.2 per cent from Ksh 12.3 billion in 2012. The number of MFBs deposit accounts stood at 1.9 million in 2013 compared to 1.6 million deposit accounts at end of 2012. The sub-sector's net loan portfolio also increased by 24 per cent from KES from 20 bn in 2012 to KES 25 bn in 2013. The sectors ratio of core capital to risk weighted assets remained constant at 15 per cent which is above the minimum requirement 10 per cent. The ratio of total capital to total risk weighted assets was 19 per cent for the period 2013 against the minimum statutory requirement of 12%. Return on Asset (ROA) was 1 per cent; the same ration attained during the period ended December 2012. The Return on Shareholders' funds remained at 7 per cent.

1.2 Research Problem

Corporate governance seeks to promote responsive and accountable firms, legitimate organizations that are managed with integrity, probity, transparency, recognition and protection of stakeholders' rights. Good corporate governance will also ensure efficient, effective and sustainable firms that contribute to the welfare of society by creating wealth, employment and solutions to emerging challenges. A well-functioning corporate governance system helps a firm to attract investment, raise funds and strengthen the foundation for firm financial performance (Donaldson, 2003).The connection between corporate governance and organizational performance lies in the multi-dimensional nature of good governance. According to Brickley

(1994), Byrd and Hickman (1992) good corporate governance enhances MFB performance. In spite of the generally accepted notion that effective corporate governance enhances MFB performance, other studies have reported a negative relationship between corporate governance and MFB performance (Hutchinson, 2002).

In the 2014 bank supervision report, the Central Bank of Kenya showed microfinance banks were able to grow their asset base by leveraging more on customer deposits as a source of funds for lending as opposed to borrowings. During the year, customer deposits accounted for 63 per cent of the microfinance banks' total funding sources compared to 60 per cent in the previous year. Borrowings as a source of funding declined, accounting for 12 per cent compared to 22 per cent in 2013. Net advances accounted for 69 per cent of the microfinance bank's total assets while net fixed assets constituted 8 per cent of the total assets base. In 2013, net advances contributed 66 per cent to the microfinance banks' total assets with net fixed assets at 9 per cent. This excellent performance of the MFBs has led to increased financial inclusion of the Kenyan population. However, lessons from the corporate collapses and losses in the last few years have highlighted the role corporate governance practices can play in maintaining viable entities and in safeguarding stakeholders‟ interests. Most of the corporate failures that were recorded in the Kenya MFB industry are examples of the risks posed by corporate governance breakdowns. For example, the collapse of Akiba Micro Finance and the current fraudulent activities by Pyramid organization masquerading as MFIs. The report by the Task force on Pyramid Schemes (2008), found that Kenyans lost more than Sh34 billion to these fraudulent schemes such as Developing Enterprise Community Initiative (DECI).

Several studies have been done to establish relationship between CG practices and financial performance. One argument is that a strong corporate governance structure could lead to a high performance (Sanda et al., 2005). It will help to promote a firm's performance and protect stake holder's interests. Nam et al. (2002) found that corporate governance should lead to better financial performance since managers are better supervised and agency costs are decreased. Poor corporate governance on the other hand is a fertile ground for corruption and poor financial performance. Brown and Marches (2003) found that firms with weaker corporate governance perform poorly compared to those with stronger corporate governance; in terms of stock returns, profitability, riskiness and dividend payments. Mwasi (2011) in her study found out that there were hardly challenges among the MFIs that were targeted in regard to CG practices; this is a good indication that MFIs in Kenya are on track with regards to implementation of corporate governance practices. However, to what extent have these practices resulted to improved performance? According to Wanjau (2007), there exist a relationship between different aspects of corporate governance and financial performance. The study found out that 70 per cent of MFIs have boards consisting of up to 10 members while 30 per cent of the MFIs have over 10 members in their board of directors. Specifically, the study found out that the size of the board was positively correlated with financial performance.

There is little research analyzing the effect of corporate governance practices on financial performance of MFBs in Kenya. Most recent researchers have delved more on the effect of CG on financial performance of MFIs which consist of NGOs, SACCOs, MFBs, credit Unions and other capacity building institutions. Only one local study (Wanjau, 2007) looked at the effect of CG on financial performance of MFIs in Kenya. It is evident that a study on the effect of CG

practices on financial performance of MFBs in Kenya is necessary. Furthermore, most MFBs in Kenya were licensed between 2009 and 2015, the Microfinance act was also enacted in 2006 and the microfinance (deposit taking institutions)regulations adopted in 2008.The question arises then: what is the effect of CG practices on financial performance of MFBs in Kenya? In line with this question and the recommendation in Wanjau (2007) and Mwasi (2011), this study will investigate the effect of corporate governance practices on financial performance of MFBs.

1.3 Research Objective

The objective of this study is to establish the effect of corporate governance practices on financial performance of MFBs in Kenya.

1.4 Value of the study

The study will play an important role in helping MFB management measure and examine their efforts and guide in improving and implementing corporate governance practices that lead to improved financial performance. The findings of this research project would contribute to improved understanding about corporate governance practices in MFBs and in what ways the banks can implement good corporate governance that aligns with performance.

The policy makers will benefit from this study by analyzing and formulating policies and regulations that will drive and enhance corporate governance implementation and adoption by MFBs in Kenya. These policies should seek to enhance financial performance thus achieving the social and profitability obligation of MFBs. The government will use the study so as to come up with policies and ways of promoting corporate governance in the MFB industry.

The empirical results will also provide general indicators of corporate governance useful for both regulator and business people in making policies and decisions as well as in rewarding or punishing the MFBs that have great or little intention to improve their corporate governance aligning with managers-owners risk-taking behavior and performance.

The researchers and academic community could use this study as a stepping stone for further studies on MFBs. This research study will also help to highlight other important variables that require further research.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

In this chapter both theoretical and empirical literature will be reviewed. The chapter reviews the literature on corporate governance and its effect on financial performance and in particular its relevance for MFBs. The chapter is organized into four sections: Theoretical review, determinants of financial performance, empirical studies and summary of the literature review. The objective of this section is to identify the potential gaps on the studies that have been conducted on corporate governance and financial performance.

2.2 Theoretical Review

This section reviews the theoretical perspectives that are relevant to this study and that are based on CG practices. More specifically, the section reviews the theoretical perspectives of governance structures and board attributes that affect financial performance. It draws on agency theory, stewardship theory, stakeholder theory and resource dependency theory.

2.2.1 Agency Theory

Agency theory is based on problems related to separation of ownership and controllability. The fundamental premise of agency theory is that the managers who possess superior knowledge and expertise about the firm are in a position to pursue self-interests rather than shareholders (owners) interests (Fama, 1980; Fama & Jensen, 1983). Eisenhardt (1989) explains that agency problem arrives when (a) the desires or goals of the principal and agent conflict and (b) it is difficult or expensive for the principal to verify what the agent is actually doing. Consequently, the monitoring of management activities is seen as a fundamental. Scholars have suggested

various governance mechanisms to address the agency problems. The governance mechanisms are designed to protect shareholder interests, minimize agency costs and ensure agent-principal interest alignment (Davis et al., 1997). Two important governance mechanisms used for this purpose are board of directors and compensation schemes to align the interests of both the agent and the principal. Fama (1980) considers the board a low-cost mechanism of management compared to other alternatives such as takeovers. The main duty of a board is to monitor management activities so that agency problems can be minimized and superior organizational performance can be achieved. The ability of management to devise and implement strategic decision making is key to financial performance. Motivating managerial personnel through good compensation and remuneration packages is consistent with the proviso of agency theory that managers are prone to act in their own interests, potentially at the expense of the interests of firms/shareholders, if their objectives are misaligned due to inadequate monitoring, bonding and compensation (Fong & Liu, 2010).

The overarching interest of shareholders is value maximization. The agency theory is concerned with reducing the agency problem which will lead to increase value maximization. It provides a direct link between corporate governance and financial performance. In agency theory, corporate governance mechanisms play an important role in ensuring the alignment of the interests of the principal and the agent, thus enriching the firm‘s capability to maximize shareholder wealth and thereby improve financial performance. The ownership structure of firms, particularly in terms of the board of directors, is the main feature mitigating the inherent dichotomy between principals and agents to improve financial performance (Harrison, 2014). Organizational factors affecting financial performance include board size, CEO duality and the presence of non-executive

directors, as well as mechanisms related to the ownership structure, such as large shareholders or concentrated ownership, the identity of shareholders (individual/family ownership, companies‘ ownership and government ownership and managerial ownership (Harrison, 2014).

In terms of corporate governance mechanisms of the board of directors (board size, CEO duality and NEDs), agency theory proposes that NEDs play an important role in monitoring and supervising executives, due to the assumption that they are independent and concerned with their own reputations (Fama & Jensen, 1983). NEDs can thus add value to firms due to their external knowledge and expertise as well as their monitoring function (Fama, 1980; Fama & Jensen, 1983). NEDs can also contribute to increasing the size of the board, which has the advantage of a wider pool of expertise but which contributes to poor decision-making and communication, reflected in the relatively poor performance of larger boards (Lipton & Lorsch, 1992; Jensen, 1993). As board size increases, the problems of coordination and communication also increase, consequently decreasing the ability of the board to monitor the management and thereby exacerbating the agency problem (Eisenberg et al., 1998). Furthermore, agency theory proposes the separation of the chairman and CEO from the same position because the primary considerations of the former include remunerating the CEO and overseeing the board; thus the combination of these roles in one person can result in increasing agency problems by diluting the effectiveness of monitoring the CEO (Jensen, 1993).

2.2.2 Stewardship Theory

In contrast to agency theory, stewardship theory presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners

(Davis & Donaldson, 1991). According to Smallman (2004), where shareholder wealth is maximized, the steward's utilities are maximized too, because organizational success will serve most requirements and the stewards will have a clear mission. The study states that stewards will balance tension between different beneficiaries and interest groups. Therefore stewardship theory is an argument put forward in financial performance that satisfies the requirements of the interested parties. A steward, who improves performance successfully, satisfies most stakeholder groups in an organization (Davis, Donaldson & Schoorman, 1997).

Stewardship theory posits that concern for their own reputations and career progression inhibits agents from acting against the interests of shareholders, thus agency costs should be inherently minimized (Davis & Donaldson, 1994). The contribution to financial performance of stewards relates to the context in terms of socio-cultural and psychological factors (Clarke, 2004). For example, managers are considered more likely to perform better with greater empowerment and job satisfaction which is a psychological factor. Socially, managers (along with most personnel in a successful organization) typically self-identify as organizational representatives and thus they consider the power accorded them by principals to be a tool to enable the organization and other employees to achieve the organizational goals. In terms of the situational perspective, it is anticipated that managers perform optimally in an environment that is involvement-oriented (i.e. in which accomplishment of tasks, control and thinking are combined in a single process). If the organizational culture has a collectivist orientation, this will obviously have implications on the long-term relationship and loyalty managers have towards the firm (Clarke, 2004). Stewardship theory supports that an insider-dominated board is more effective due to more in-depth knowledge of organizational operations, such as access to data and technical expertise (Muth &

Donaldson, 1998). Additionally, CEO-Chairman duality will make leadership and control, particularly regarding decision making and strategy (e.g. investment) more consistent, which is presumed to contribute to greater effectiveness (Davis, Donaldson & Schoorman, 1997). Because the inside directors have more comprehensive and deep knowledge of daily operations within firms, their decisions are better informed.

According to stewardship theory, they are therefore preferable to NEDs due to their more accurate knowledge of financial performance. With fewer inside directors, boards have reduced insight into the company's situation and progress, rendering them reliant on information furnished by the management, with little or no contextual knowledge to make any decisions independent of the recommendations of managers; NEDs suffer from this same lack of knowledge as the board in general. Reduced ability to monitor managers and the making of less informed decisions by boards comprising outsiders means that such boards are unlikely to improve financial performance to the same extent as boards with a larger number of insider directors according to stewardship theory. When the position of the CEO and Chairman is held by a single person, the fate of the organization and the power to determine strategy is the responsibility of a single person. Thus the focus of stewardship theory is on structures that facilitate and empower rather than monitor and control (Davis, Donaldson & Schoorman, 1997). Therefore stewardship theory takes a more relaxed view of the separation of the role of chairman and CEO, and supports appointment of a single person for the position of chairman and CEO and a majority of specialist executive directors rather than non-executive directors (Clarke, 2004).

2.2.3 Resource Dependency Theory

The basic proposition of resource dependence theory is the need for environmental linkages between the firm and outside resources. In this perspective, directors serve to connect the firm with external factors by co-opting the resources needed to survive (Pfeffer & Salancik, 1978). Thus, boards of directors are an important mechanism for absorbing critical elements of environmental uncertainty into the firm. Williamson (1985) held that environmental linkages or network governance could reduce transaction costs associated with environmental interdependency and thus improve financial performance. Further, the uneven distribution of needed resources results in interdependence in organizational relationships. Several factors would appear to intensify the character of this dependence, e.g. the importance of the resource(s), the relative shortage of the resource(s) and the extent to which the resource(s) is concentrated in the environment (Davis & Donaldson, 1991). Additionally, directors may serve to link the external resources with the firm to overwhelm uncertainty (Cannella Jr, Hillman & Paetzols, 2000), because managing effectively with uncertainty is crucial for the existence and better performance of the company. According to the resource dependency rule, the directors bring resources such as information, skills, key constituents (suppliers, buyers, public policy decision makers, social groups) and legitimacy that will reduce uncertainty (Gales & Kesner, 1994). Thus, Hillman et al. (2000) consider the potential results of connecting the firm with external environmental factors and reducing uncertainty is decrease the transaction cost associated with external association.

Pfeffer (1972), Pfeffer and Salancik (1978) argued that the diversity of the board size and the background of the outside directors are very important elements in managing the

company needs for any capital in the future or to manage environment contingency. Pearce and Zahra (1992) also assert that diversifying the board will help the company to survive by benefiting from the exchange of company resources and its external environment. In addition, they report that the presence of the outside directors will result in improving the organization efficient strategies by providing the firm with new viewpoints and perspectives, which will ultimately improve the financial performance. Carpenter and Westphal (2001) confirmed on Pearce and Zahra‘s (1992) study by pointing that a firm’s links help them secure their business interests in the event of environmental uncertainty. In addition, the resource dependence theory clarifies the methods that firms use in order to gain access to financial resources. In terms of solvency problems companies are highly advised to appoint representatives of the financial institutions on their boards (Mizruchi & Stearns, 1988). However, if the firm is in high levels of bank debt, it is likely they will appoint an officer of the creditor bank inside the board to facilitate access to finance. In other words, it is an easier way of access to credit (McEwen & Thompson, 1958). Mizruchi and Stearns (1993) report that there is a significant relationship between the identities of the financial representatives and a firm‘s borrowing strategy. Moreover, Kaplan and Minton (1994) identified that firms often wish to appoint financial directors on the board if the prices of the stocks or the performance of the company deteriorate. In addition, inside directors are recommended to be replaced with experienced outside directors when the firm performance worsens (Hermalin & Weishbach, 1988).

The resource dependence theory uses the external linkages of the board in order to add value to the firm and improve the firm performance (Donaldson & Muth, 1998; Kiel & Nicholson, 2007). Hitt et al. (2000) argued that emerging market countries suffer from low availability of capital,

high costs, poorly developed financial markets and volatility in economic development. These conditions produce a resource gap between firms in emerging markets and those in developed markets. Therefore, companies are forced to find a creative way to benefit from the external links of the board. In other words, in developing countries it is always important for companies to have links with external resources. In conclusion, resource dependence theory holds that the operational environment of the firm is reflected in its board structure (Boyd, 1990; Hillman et al. 2000; Pfeffer, 1972) which entails that directors are selected according to their ability to facilitate access to required resources. Thus, it should be possible to identify firm dependencies from the board composition; for example, the presence of financiers in the board of directors suggests that firms seek cheap access to capital, from which it can be inferred that they plan large investment or that they are in financial difficulty (Hillman et al. 2000). Generally, a board with diverse members with varied links to external resources can be expected to have greater access to such resources, which enhances firm performance and value.

2.2.4 Stakeholder Theory

This theory centers on the issues concerning the stakeholders in an institution. It stipulates that a corporate entity invariably seeks to provide a balance between the interests of its diverse stakeholders in order to ensure that each interest constituency receives some degree of satisfaction (Abrams, 1951).There is an argument that the Agency theory is narrow because it identifies the shareholders as the only interest group of a corporate entity. However, the stakeholder theory is better in explaining the role of corporate governance than the agency theory by highlighting different constituents of a firm (Coleman et al., 2008). Stakeholder theory has become more prominent because many researchers have recognized that the activities of a

corporate entity impact on the external environment requiring accountability of the organization to a wider audience than simply its shareholders. Indeed, it has been realized that economic value is created by people who voluntarily come together and cooperate to improve everyone's position (Freeman et al., 2004). Jensen (2001) critiques the Stakeholder theory for assuming a single-valued objective (gains that accrue to a firm's constituency). 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.

Stakeholder theory recognizes that many groups have connections with the firm and are affected by firm's decision making. Freeman et al. (2004) suggest that the idea of value creation and trade is intimately connected to the idea of creating value for shareholders. Donaldson and Preston (1995) refer to the myriad participants who seek multiple and sometimes diverging goals. Manager's view of the stakeholders' position in the firm influences managerial behavior. However, Freeman et al. (2004) suggest that managers should try to create as much value for stakeholders as possible by resolving existing conflicts among them so that the stakeholders do not exit the deal. Carver and Oliver (2002) examine stakeholder view from non-financial outcomes. For example, while shareholders generally define value in financial terms, others stakeholders may seek benefits such as the satisfaction of pioneering a particular breakthrough, supporting a particular kind of corporate behavior or where the owner is also the operator, working in a particular way. It means stakeholders have 'non equity stakes' which requires management to develop and maintain all stakeholder relationships, and not of just shareholders. This suggests the need for reassessing performance evaluation based on traditional measures of shareholder wealth and profits by including measures relating to different stakeholder groups

who have non-equity stakes. Nonetheless many firms do strive to maximize shareholder value while, at the same time, trying to take into account the interest of the other stakeholders.

2.3 Determinants of Financial Performance of Microfinance Banks

The section reviews the main determinants of financial performance of MFBs. Corporate governance has been identified to affect financial performance of firms as elaborated in the empirical and theoretical reviews. Other determinants of financial performance include: firm size, firm age and macroeconomic elements (interest rates, economic growth measured in GDP and inflation).

2.3.1 Corporate Governance

Corporate Governance has been identified as one of the determinants of financial performance. Effective corporate governance should fundamentally guarantee shareholders' value by ensuring the appropriate use of firms' resources, enabling access to capital and improving investor confidence (Denis & McConnell, 2003). This is related both to internal organization and external market conditions; firm‘s responsiveness to external conditions is largely dependent on the way the firm is managed as well as the efficacy of the firm‘s governance structure (Gregory & Simms, 1999). Nam et al. (2004) argued that good corporate governance prevents the expropriation of company resources by managers, ensuring better decision making and efficient management. This results in better allocation of company resources and, ultimately, improved performance.

Claessens (2003) also argues that better corporate governance frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favorable treatment of all stakeholders. The position has been stated that, weak corporate governance does not only lead to poor financial performance and risky financing patterns, but are also conducive to macroeconomic crises like the 1997 East Asia crisis. Other researchers contend that good corporate governance is important for increasing investor confidence and market liquidity (Donaldson, 2003).Again, poorly governed firms are expected to be less profitably, have more bankruptcy risks, lower valuations and pay out less to their shareholders, while well-governed firms are expected to have higher profits, less bankruptcy risks, higher valuations and pay out more cash to their shareholders.

2.3.2 Firm Size

The financial performance of a firm is a function of many different factors. The size of the firm has been shown to have an effect on performance due to the advantages and disadvantages faced by firms with a particular level of growth. According to Chandler (1962), large firms can operate at low costs due to economies of scale. Cull et al. (2007) found out that the size of an MFI is significantly positively linked to its financial performance. Large MFIs have easier access to finance, possess a larger pool of qualified human capital and have a greater chance for strategic diversification (Chen & Yang, 2009). Large MFIs also have superior capabilities in product development, marketing and commercialization (Teece, 1986). The size of the firm is not always advantageous as it can result to declining performance due to some operational behavior of the firms.

According to Gavetti and Tripsas (2000), large firms in some cases are slow to introduce and adopt new technologies due to the bureaucracy and operational rigidities. Large firms also have a tendency to focus only on existing market unlike small firms which seek to capture new and potential markets. A study undertaken by Dietich and wanzenried (2009) in the banking industry, that is determinants of profitability in commercial bank, show that larger banks are slightly less profitable than medium sized banks, with the coefficients being significant at the 10% level. This gives some indication that larger banks cannot benefit from higher product and loan diversification possibilities and even face scale inefficiencies. There is consensus in academic literature that economies of scale and synergies arise up to a certain level of size. Beyond that level, financial organizations become too complex to manage and diseconomies of scale arise. The effect of size could therefore be nonlinear (Amdemikael, 2012). It is argued that failure to become profitable in microfinance is partly due to lack of scale economies (Muriu, 2011). This implies that profitable MFIs in Africa have a greater control of the domestic market, and therefore lending rates may remain high while deposit rates remain lower since larger MFIs may be perceived to be safer, therefore this high interest rate spread translates to and sustains higher profits margins.

2.3.3 Firm Age

Firm age is also an important attribute on the firm's financial performance as it tells about the experience possessed by the firm in their operations. According to Ericson and Pakes (1995), firms are learning and over time they discover how to be more efficient. Through learning, firms specialize and find ways to standardize coordinate and speed up their production processes as well as reduce costs and improve quality. The relationship between firm age and organizational

performance can be explained from different dimensions. According to Jovanovic (1982), firms are born with fixed productivity levels which increase with time. This is so called selection effects which arise when competitive and other operational pressure eliminates the weakest firm in the market. As results of the decreased number of firms, the remaining firms are faced with high market demand which facilitate increased average productivity level (Coad et al., 2011).

According to Cull et al. (2007), sustainability could relate to the age of MFI. The age refers to the period that an MFI has been in operation since its initial inception. Studies indicate that the MFIs age relates to the financial performance. Jorgensen (2011) states that age, is grouping by new (1 to 4 years), young (5-8 years) or mature (more than 8 years). The number of years is calculated as the difference between the year they started their microfinance operations and the year of data submitted by the institutions. This studies show that age is significant with a positive sign.

2.3.4 Macroeconomic Variables

Njuguna (2013) found out that MFI financial performance could be determined to a very large extent by three macro-economic variables, namely economic growth (measured by GDP), interest rates and inflation. It was found that increase in GDP led to increased MFI performance as measured by return on assets (ROA), increase in interest rates led to a decrease in ROA. Poor economic conditions can worsen the quality of the loan portfolio, thereby reducing profitability. In contrast, an improvement in economic conditions has positive effect on the profitability of MFIs (Muriuri, 2011). Thus, the variable is expected to exhibit positive relationship with MFIs profitability. According to the study undertaken by Imai et al. (2012), working paper entitled

financial performance of microfinance institutions: A macroeconomic and institutional perspective, found that GDP has a positive effect on MFIs financial performance.

McGuire and Conroy (1998) looked at microfinance financial performance and the domestic economy by looking at percentage changes or simply levels of financial indicators during periods of economic crisis. They used survey data to observe the effects of the Asian financial crisis on MFI in nine countries by looking at percentage changes in loans, savings, total assets, and capital stocks of microfinance institutions over six-month periods from 1996 to 1998. Interestingly, they found that MFIs were able to maintain relatively better financial performance, especially among those institutions that serviced poor clients. Their survey found that the economic crisis had the least impact on MFIs operating in the poorest countries and that institutions with poorer borrowers were better off. While commercial banks had to substantially raise interest rates, village MFIs were able to maintain relatively lower interest rates. Rather than looking at the changes in financial indicators, other studies have observed the levels of these indicators and compared them to commercial banks in the same countries.

2.4 Empirical Studies

This section reviews five local and global empirical studies on the effect of corporate governance on financial performance of MFIs. Coleman and Biekpe (2008) studied the relationship between board size, board characteristics, board composition, CEO duality and firm performance of non-financial firms in Ghana. The study employed secondary data based on the financial statements of all the 16 listed non-financial firms on the Ghana Stock Exchange for eleven year period (1990 to 2001). The study analyzed the data using a multiple regression model, a modified version of the econometric model of Miyajima et al. (2003). The study found out that the size of

the board is positively related to ROA suggesting on the contrary that firms should have larger board sizes. This contradicts findings made by researchers such as Lipton and Lorsch (1992), Eisenberg et al. (1998), and Sanda et al. (2003). Board composition also had a negative impact on firms' profitability re-echoing the fact that the independence of a board is not really critical for the effective performance of any firm.

Gadi (2015) in the study, the impact of corporate governance on the financial performance of micro-finance banks in North Central Nigeria using the Pearson correlation established a significant relationship between earnings per share (EPS) and corporate governance practices (Board size, board independence, gender diversity and composition of board committees). The regression analysis showed that no significant relationship existed between corporate governance and bank's financial performance. The study used data gathered from annual reports and accounts of the 23 micro-finance banks out of a total population of 158 micro-finance banks.

Hartarska (2004) studied the governance and performance of microfinance institutions in Central and Eastern Europe and the newly independent states. The study used data from three surveys that were conducted in 1998, 2001 and 2002. The study which used regression analysis established that performance seemed to improve with size and after a point decreased. The proportion of women also had a positive effect on financial performance as the coefficient was positive and statistically significant in the operational self-sustainability equation. Expatriates influenced financial sustainability negatively perhaps because they bring easy donation or grants. Boards with higher proportion of insiders had less active borrowers and low ROA. The most surprising result here is that client outreach was negatively affected by the proportion of donor representatives on the board. This result confirms the notion that donors funding MFIs focus more on financial results than on outreach.

Sseremba (2006) undertook a cross sectional survey to establish the relationship between ownership structures, corporate governance and performance of MFIs in Uganda. The study used data from a sample of 65 MFI firms out of a population of 69 and analyzed the data using Pearson's correlation coefficient. The study established a significant positive relationship with the performance of these MFIs; ($r = 0.352^{**}$, $p<.01$) and ($r = 0.337^{**}$, $p<.01$) respectively. However this relationship is not so strong for these small MFIs. This implies that although corporate governance affects performance positively, there are other factors that have a stronger influence on performance in these small MFIs than corporate governance.

Mori and Olomi (2012) in the study, effects of board on the performance of MFIs in Tanzania and Kenya, failed to find a significant difference in the performance between boards with internal board members versus those with external members. However, the study observed that local board members are associated with higher ROA and higher OSS. These findings contradict international literature which posits that international boards lead to good financial performance (Mersland et al., 2011). While international board members tend to push for sustainability, they also want the MFI to keep interest rates low, whereas nationals are more open to keeping interest rates high as a way of ensuring sustainability. The finding may also suggest that national board members' local knowledge may be important for MFIs' ability to manage costs and generate income.

Locally, studies have been undertaken on the effect of corporate governance on financial performance of MFIs and other institutions. Wanjau (2007) in the study, the relationship between CG and performance of MFIs in Kenya, surveyed 15 registered MFIs out of a population of 100 and analyzed data using basic frequency distribution and percentages. The study found out that there exist a relationship between different aspects of corporate governance and firm

performance. Specifically, the study found out that the size of the board was positively correlated with turn-over or disbursements. This means that large boards translate to higher turn-over for MFIs.

Oluoch (2013) sought to analyze how corporate governance practices affect the financial performance of SACCOs within Nairobi County. The research focused on the thirty-four (34) licensed deposit taking SACCOs within Nairobi County. The study sampled observations for the five-year period between 2008 and 2012. A multiple regression model of financial performance versus corporate governance characteristics was applied to examine the relationship between the variables. The study established that board meeting frequency, audit committee size and audit committee meeting frequency have positive relations to the financial performance indicator as measured by Return on Assets. However, there were indicators that never had a bearing on the performance indicator (ROA), and this can be attributed to the fact that they remained constant over the whole study period. These indicators are board committee size, composition of audit committee and board size.

Maranga (2014) investigated the effect of corporate governance on financial performance of Small and Medium Enterprises in Nairobi County, Kenya. The study made used primary data collected using questionnaires. The population included all the SMEs in Nairobi County operating as at 30th December 2013 and a sample from each category of business was identified and used to collect information. Data was analyzed using a multiple linear regression model. The study found that there is a significant strong relationship between the SME‟s financial performance and corporate governance. The number of board meetings, number of board sub-committees‟ meetings, and the size/age of the SMEs were found to significantly affect the financial performance of SMEs in a positive direction. The CEO duality was however noted to

be common in most SMEs. The study recommended that the government of Kenya should support the SMEs by providing incentives to help them in implementing corporate governance practices.

Odondi (2011) studied the impact of corporate governance on the financial performance of CBO's in Kibera. The target population included all CBOs implementing health strategies in Kibera. The research instrument used in data collection was a questionnaire. Data was summarized into frequencies and percentages and presented in tables. The study found out that the board size and composition, separation of ownership and control, independence of committees and financial reporting to a very great extent affect the performance of the organization.

Muriuki (2012) examined the effect of board gender composition on the financial performance of listed companies based on evidence from Kenya during a five year period (2007 - 2011). Board gender composition was calculated as the proportion of board seats that women occupy in these listed firms, while financial performance was measured by the return on assets (ROA). This study used secondary data collected from published annual reports and a cross sectional research design was used to provide a snap shot of the population at a single point in time. The data was analyzed using Statistical Package for the Social Sciences (SPSS). Regression analysis was used to determine the relationship between board gender composition and the performance of listed companies. The research finding indicated that there is a negative relationship between gender diversity and firm financial performance. The implication of these findings is that an increase in the number of board seats for women may affect the company's performance negatively.

2.5 Summary of Literature Review

The section elaborated on four theoretical perspectives; agency theory that supports management monitoring, stewardship theory backing managerial empowerment, resource dependence theory supporting environment co-option and stakeholder theory proposing equity among all stakeholders. The most common determinants of financial performance as illustrated in the section included; corporate governance practices, firm size, firm age, economic growth, interest rates and inflation.

Several studies discussed in this section are an indication that corporate governance practices affect the financial performance of MFIs. Most of the studies have analyzed the effect of CG on financial performance of MFIs. The studies have done a review on the effect of board structure, characteristics and composition on firm performance but none has reviewed the effect of board processes on financial performance of firms. Only one local study looked at the effect of CG on financial performance of MFBs in 2007. It is evident that a study on the effect of CG practices on financial performance of MFBs in Kenya is necessary, given the fact that most MFBs in Kenya were licensed in period 2009-2015, the Microfinance act was also enacted in 2006 and the Microfinance (Deposit Taking Institutions) Regulations adopted in 2008.The studies used different models to analyze the relationship between CG and financial performance. The most common models used are: Pearson correlation, regression and simple frequency distribution and percentage analysis. Most local studies were based on SACCOs and listed companies.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This section expounded in detail the methodology of the research. It discussed the research design used. It also described the target population, data collection methods, analysis processes, the analytical model and data presentation methods that were employed in the study.

3.2 Research Design

The study applied descriptive cross-sectional design. A descriptive cross-sectional study is a study in which potentially related factors are measured at a specific point in time for a defined population. Descriptive studies are usually the best methods for collecting information that demonstrate and describe relationships. According to Cooper and Schindler (2003), a descriptive study is one that finds out the what, where and how of a phenomenon. Muriuki (2012) used descriptive cross-sectional design to examine the effect of board gender composition on the financial performance of listed companies based on evidence from Kenya. Thus, this approach was found appropriate for this study, since the researcher intended to describe the existing relationship between CG and financial performance at a particular point in time.

3.3 Population

The population of interest consisted of 9 micro-finance banks licensed by CBK as at 31st December, 2014. MFBs in Kenya are in different stages of development and exhibit high level of diversity in aspects such as ownership and leadership. In order to address these differences and obtain a relevant result which is representative, a census was done. A census was found appropriate given the small number of respondents targeted, time and resource limitations.

3.4 Data Collection

The study applied secondary data to draw a conclusion. Data for the study covered a five year period from 2010 to 2014. The main sources of secondary data included past and immediate annual reports, financial statements (income statements, statements of the financial position and cash flow statements), books, journals and other publications on MFBs in Kenya.

3.5 Data Validity and Reliability

Reliability is the measure of the degree to which a research instruments yields to consistent results and data after repeated trials (Mugenda & Mugenda, 1999). Data validity has to do with the representation of the sample with regard to the target population. Validity concerns the accuracy and meaningfulness of inferences which are based on the research results (Cooper & Schindler, 2001). Data reliability was achieved by ensuring that the information was not biased, was written by a qualified person, retrieved from a reputable site, current and that it referred to data and statistics from valid first-hand investigations. Data was also analyzed to ensure accuracy by checking if information can be substantiated in more than one reliable source. Validity of data was achieved by ensuring measurements used in secondary sources are actually measuring what is intended to measure, incorporates suitable equipment, controlled variables and appropriate measuring procedures.

3.6 Data Analysis

The data was analyzed using both descriptive and inferential statistics. Descriptive statistics was computed to obtain a general understanding of the firm and respondents characteristics. Inferential statistics was computed to test a number of hypothesized relationships. The

methodological approach used in most previous work examining the effect of corporate governance on financial performance variables is the multiple regression (Coleman & Biekpe, 2008). Thus, the study employed multiple regression model. The analytical model was as follows:

$Y_i = B_0 + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + e$

Where:

Y_i represents financial performance. Return on assets (ROA) was used as a proxy for financial performance. USAID Microenterprise Development Office in its, "Financial Reporting Standards" recommends the use of ROA and ROE as measures of MFI profitability. ROA is consistently claimed to be an authentic measure of Financial Performance (Berman et al., 1999).

B_0 is financial performance without effect of corporate governance

X_1 is Board Size. BDS measured by the natural logarithm of the number of board members (Adams & Mehran, 2005)

X_2 is Board Gender Diversity. BDG measured by the ratio of female board directors over the total number of board members.

$X_{3\ is}$ Board Independence. BDI measured by ratio of the proportion of non-executive directors to the total board members.

X_4 is control variable (Size of the Firm). Total amount of assets was used as a proxy for firm size. The size of the MFB was measured by the natural logarithm of total assets (Adams & Mehran, 2005)

e is the error term of the test equation.

The significance of each independent variable was tested. Fischer distribution test, F-test was applied. It refers to the ratio between the model mean square divided by the error mean square. F-test was used to test the significance of the overall model at a 95 percent confidence level. The p-value for the F-statistic was applied in determining the robustness of the model. The conclusion was based on the basis of F calculated and F- critical where if the null hypothesis of the beta is rejected then the overall model is significant (if the p-value is less than 0.05) and if null hypothesis is accepted (If the p-value is greater than 0.05) the overall model is insignificant and was not used to explain the variations in the dependent variable.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The objective of the study was to establish the effect of corporate governance practices on financial performance of microfinance banks in Kenya. In order to achieve this objective, statistical analysis was done for 9 microfinance banks licensed by the CBK as at December 31st 2014 for the period 2010-2014 (Appendix 1). Computer software SPSS was used to extract the correlation and regression statistics of the variables. This chapter presents analysis and findings of the study as set out in the research methodology.

4.2 Response Rate

There was 80% response rate from the microfinance banks and Central Bank of Kenya in providing the secondary data. However, only 75% of the micro finance banks made disclosures on corporate governance aspects relevant to this study.

4.3 Data Validity

Data validity has to do with the representation of the sample with regard to the target population. Validity concerns the accuracy and meaningfulness of inferences which are based on the research results (Cooper and Schindler, 2001). Validity of data was achieved by ensuring measurements used in secondary sources are actually measuring what is intended to measure, incorporates suitable equipment, controlled variables and appropriate measuring procedures. Data was retrieved from the MFBs annual reports filed with CBK. This ensured and ascertained validity since data in the annual reports measure financial performance and corporate governance practices. For example disclosures on board meetings and board size in the annual reports are

some of the measures of CG. Additionally, since a census was done, the population characteristics were well represented and captured thus achieving high data validity.

4.4 Descriptive Statistics

This section deals with the descriptive statistics for the data that was used in the analysis of this study. The main features of the data will be described quantitatively (e.g. central tendency of the statistics such as mean, max and min, data dispersion such as standard deviation was used). The whole table for the descriptive statistics of this study is presented in appendix 2. The table shows that the highest ROA average for the five year period was in 2010 with -0.0089 while the lowest was in 2013 with -0.0217. The ROA ranged from a maximum of 0.0248 in 2012 and a minimum of -0.1727 in 2014. The total assets ranged from a minimum of 58 million in 2012 to a maximum of 26 billion in 2014. Kenya Women Fund Trust had the highest amount of total assets in 2014 (Appendix 3). The table shows that in general the board size ranged between a minimum of 5 and a maximum of 14. Remu had the largest board size of 14 in 2014 (Appendix 3). The mean board size varied between 8 to 9 over the five year period. This confirms that microfinance banks in Kenya, on average, have met the requirements of the Microfinance (Deposit- Taking Microfinance Institutions) Regulations (2008), commensurate with the recommendations of Jensen (1993) and Lipton and Lorsch (1992). Based on their investigation of financial performance in relation to board size, they recommended 8 to 9 directors, and specified that 10 should be the maximum number. This relatively small board size as recommended by Jensen (1993) can be attributed to the fact that more people inhibit the process of making decisions (i.e. causing indecisiveness or incoherent decisions due to the fissiparous decision-making process among many parties). Interestingly, it has been found that firms in developing countries typically

have smaller board sizes. The average board size similar in Egypt and Malaysia is 8 directors (Elsayed, 2007; Haniffa and Hudaib, 2006), while the average board size in the US is 12 (Yermack, 1996). However, the board size is significantly smaller in Australia, averaging 7 (Kiel and Nicholson, 2003).

4.5 Correlation Analysis

Table 4.5.1 below reveals a number of significant correlation among the dependent and independent variables. The analysis shows that ROA is positively correlated with board and firm size and negatively associated with proportion of NEDs and board gender diversity. However, there is a weak correlation or association between ROA and board size (r=12.9%), marginally strong correlation between ROA and proportion of NEDs (r=31.6%) and a very weak correlation between ROA and board gender diversity (r=-3%). On the other hand there is an averagely strong association between ROA and firm size. The results further show that only board gender diversity and firm size with r = 0.60 (60%) and proportion of NEDs and firm size with r= 0.67 (67%) have the highest correlation.

Table 4.5.1: Correlation Results

	ROA	**BDS**	**NEDs**	**BDG**	**Total Assets**
ROA	1.0000				
BDS	0.1292	1.0000			
NEDs	-0.3155	-0.1656	1.0000		
BDG	-0.0301	0.3936	-0.4861	1.0000	
Total Assets	0.5204	0.0348	-0.6704	0.6003	1.0000

4.6 Regression Analysis and Hypothesis Testing

The study used regression analysis to compare with the result obtained from the Pearson correlation coefficient. The model was subjected to linear regression in order to determine the nature of relationship between the independent and the dependent variables. The findings are presented in Table 4.6.1 below:

Table 4.6.1: Regression Results

$ROA= -0.6896+ 0.0742 X_1 + 0.0212 X_2 – 0.1763X_3+ 0.0261X_4 + e$				
	Coefficients	Standard Error	t Stat	P-value
Intercept	-0.6896	0.1723	-4.0027	0.0004
BDS	0.0742	0.0263	2.8253	0.0088
BDI: NEDs	0.0212	0.0746	0.2843	0.7783
BDG	-0.1763	0.0408	-4.3216	0.0002
Total Assets	0.0261	0.0051	5.1151	0.0000

* Denotes significance at 5% level (P-values less than 0.05)

The findings of Table 4.6.1 above indicate that three of the four independent variables were found to be significant at 95% level of confidence. They include: board size, gender diversity and firm size. This indicates that the extent of financial performance of microfinance banks in Kenya is influenced by board gender diversity, board size and firm size. However, proportion of NEDs was found to be insignificant at the 95% level of significance. This indicates that the proportion of NEDs have an insignificant effect on financial performance. Table 4.6.2 below presents the regression model fitness results. The coefficient of determination, R squared which is 57.9%, shows that the regression model is averagely well explained by the variables. This

implies that the financial performance is explained by the independent variables (board size, proportions of NEDs, board gender diversity and firm size) up to 57.9% while the rest is explained by other variables not captured in this model.

Table 4.6.2: Regression Model Fitness Results: Coefficient of Determination

Regression Statistics	
Multiple R	76.09%
R Square	57.90%
Adjusted R Square	51.66%
Standard Error	3.69%
Observations	32

Making references about the population in regression, the study looked at whether a significant relationship exists between financial performance and each of the independent variables. The hypothesis can be stated as follows under a two tailed test

H0: $\beta 1 = \beta 2 = \beta 3 = \beta 4 = \beta 5 = 0$

(There is no significant relationship between firm performance and the independent variables)

H1: $\beta 1 = \beta 2 = \beta 3 = \beta 4 = \beta 5 \neq 0$

(There is a significant relationship between firm performance and the independent variables)

Where β_i is the coefficient of board size, proportion of non-executive directors, gender diversity and firm size. From the above, where $p < 0.05$, the study rejects the null hypothesis and concluded that firm size, board size and gender diversity have significant effect on financial performance and thus accept the alternative hypothesis. On other hand, where $p > 0.05$, the study

fails to rejects the null hypothesis and concludes that proportion of non-executive board directors have no significant effect on financial performance. The calculated p value of 0.0001 < 0.05 for the overall model as presented in table 4.6.3 below, the study rejects the null hypothesis and accepts the alternative hypothesis indicating that the independent variables have a significant effect on financial performance.

Table 4.6.3: ANOVA

	Df	**SS**	**MS**	**F**	**Significance F**
Regression	4	0.0506	0.0126	9.2829	0.0001
Residual	27	0.0368	0.0014		
Total	31	0.0873			

Table 4.6.3 above presents the ANOVA results. ANOVA statistics indicate that the overall model was significant. This was supported by an F statistic of 9.2829 and p value of 0.0001. The reported probability was less than the conventional probability of 0.05 (5%) significance level. The ANOVA results imply that the independent variables are good joint predictors of financial performance.

4.7 Discussion of Research Findings

This section will deal with the main inferences which were drawn from the model regression and correlation analysis. Discussions will be made in four main sections (i.e. board size, proportion of NEDs, board gender diversity and firm size).This is simply to facilitate the presentation of results and to make the findings more understandable by focusing on each type of effect.

4.7.1 Board Size

Both Pearson Correlation and regression model established a positive relationship between board size and financial performance i.e. ROA. The relationship as presented by the correlation coefficient and p value of 0.1292 and 0.009 respectively reveal a weak positive correlation and positive significant effect on financial performance. This therefore means that an increase in board size would result to an increase in financial performance of microfinance banks. However the increase as presented by the correlation coefficient is very marginal. On the other hand, the regression model reveals that board size has a significant effect on financial performance. This is in line with the findings of Dalton et al. (1999). Other studies like Miller (2003), Gales and Kesner (1994), Hillman and Dalziel (2003) and Lehn et al. (2009) argue that larger boards are better than the small ones in improving firm performance. The possible explanation for this could be that large boards have improved linkages and networking with external sources of skills, expertise and capital to benefit from.

4.7.2 Proportion of NEDs

There were contradicting findings from the Pearson correlation and regression model. The Pearson correlation model established a negative correlation between proportion of NEDs and financial performance while regression model established a positive relationship. However the relationship was insignificant as presented by the P value of 0.78 which is way more than the conventional probability of 0.05 and a marginally strong correlation coefficient of –0.32. The Pearson correlation finding is consistent with some previous studies (Agrawal and Knoeber, 1996; Bhagat and Black, 1998; Weir and Laing, 2003; Yermack, 1996), which reported that firms with higher proportions of NEDs are more likely to experience lower performance because

NEDs are part-time workers, unfamiliar with the operations and company business, who are unable to comprehend the complications and difficulties that face the company. However, this is inconsistent with the monitoring hypothesis of agency theory, which holds that the presence of a larger proportion of NEDs in the board adds value to the firm by providing the firm with independent decisions and judgments (Cadbury Report, 1992; Chhaochharia and Grinstein, 2009), playing an important role in the board as a source of experience, monitoring services, reputation and expert knowledge (Baranchuk and Dybvig, 2009; Haniffa and Hudaib, 2006).

4.7.3 Board Gender Diversity

Both Pearson and regression model established a negative correlation and relationship between the proportion of female directors in the board and financial performance. The correlation model presents a very weak association with financial performance as presented by r=-3%, while the regression model presents a significant effect as presented by a p value of 0.0002 These findings are consistent with Daniel et al. (2015), in the study; Board gender diversity and firm performance: Empirical evidence from Hong Kong, South Korea, Malaysia and Singapore. The study established that the positive effects of gender diversity diminish in MFBs with higher female economic participation and empowerment. This may be due to tokenism and suggests that forcing female director appointment or mandating gender quotas can reduce financial performance in MFBs with strong cultural resistance. 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.

4.7.4 Firm Size

As shown earlier in chapter three, total assets was used as a proxy to measure the MFB size. In line with earlier studies, total asset is transformed into logs, to reduce their skewness or kurtosis and mitigate influence of the outlier data points. The results in both the Pearson correlation and regression model report a positive and strong statistically significant effect of the MFB size on financial performance as measured by ROA. These positive results indicate that large MFBs may benefit from economies of scale and scope (John, 2003). The size of a MFB reflects its ability to achieve economies of scale as well as a market power. In addition, the larger a MFB the more likely it can use its economies of scale to develop efficient processes that enhance financial performance. Therefore, big MFBs have greater ability to secure finance. Furthermore, large MFBs are in better position to generate funds internally and access external resources (Short and Keasey, 1999). Meek et al. (1995) point out that in terms of market development and business risk, large MFBs tend to be more complex, more diversified and have larger information sets than small MFBs. Furthermore, positive effect indicates that larger MFBs are more likely to have broader activities, value creation sources and influence on the market. Also, this means that large MFBs can borrow on better conditions since large MFBs tend to own larger assets which can be used as collateral.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

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

5.2 Summary of Findings

The objective of this study was to establish the effect of the corporate governance on the financial performance of microfinance banks licensed by the CBK as at December 31st 2014 during the period 2010 to 2014. The study examined the effect of the corporate governance practices (e.g., board size, proportion of NEDs and board gender diversity) and a control variable; firm size. The data set used in this study to examine this relationship was extracted from the microfinance banks annual reports. The study used a population of 9 microfinance banks licensed by the CBK as at December 31st 2014. Multiple regression and Pearson Correlation analysis were chosen as the main tool of analysis. The data on corporate governance practices (board of directors' structure) and accounting based measures of financial performance (ROA) revealed a mixed set of results in terms of agency perspectives.

In terms of board and firm size, regression model findings revealed a positive significant relationship with financial performance as presented by a p value of 0.009 and 0.000 respectively. The model also established a negative significant relationship between the presence of female board directors and financial performance as indicated by a p value of 0.0002. This may be due to tokenism that suggests that forcing female director appointment or mandating

gender quotas can reduce firm performance in MFBs with strong cultural resistance. This may also be explained by the fact that the positive effects of gender diversity may diminish in MFBs with higher female economic participation and empowerment. The model further established a positive insignificant relationship between proportion of NEDs and financial performance as indicated by a p value of 0.78. This result may be explained by the fact that NEDs are commonly part-time workers; this will undermine their ability to monitor and advise the board because of the lack of information which reduces the NEDs'ability to apply their function efficiently. These results are inconsistent with agency theory.

5.3 Conclusion

The board size indicated a significant positive relationship to the dependent variable (financial performance measured by ROA) as presented by a p value of 0.009 which is less than the conventional probability of 0.05; aside board gender diversity showed a negative significant effect on the financial performance as presented by a p value of 0.0002, while proportion of NEDs showed a positive insignificant relationship to financial performance. The possible explanation for this phenomenon could be that firms with higher proportions of NEDs are more likely to experience lower performance because NEDs are part-time workers, unfamiliar with the operations and company business, and are unable to comprehend the complications and difficulties that face the company.

The trend in ROA and growth in total assets as shown in appendix 4 indicate that there has been a tremendous improvement in the financial performance of MFBs. These results can be attributed to the adoption and implementation of corporate governance practices. This shows that the

corporate governance has an effect on the financial performance of microfinance banks in Kenya as presented by a strong regression coefficient of 57.9% and an overall p value of the model of 0.0001 which is way less than the conventional 0.05. The results of the study show that good corporate governance practices enhance financial performance and when these factors are capitalized they enhance MFB value.

5.4 Recommendations

Microfinance banks in Kenya should embrace corporate governance practices for them to enhance shareholder wealth maximization and profitability. CBK through their prudential regulations should ensure that microfinance banks follow these regulations which ensure adequate risk management measures are followed not only in writing but in day to day operations of microfinance banks.

In a bid to improve female representation in boards of MFBs in Kenya, CBK should introduce a regulation requiring a given percentage of female representation in boards. In as much as the findings drew a negative relationship between board-gender diversity and financial performance, it may help break the male dominance in some microfinance banks, empower women to top positions and perhaps this could form a basis of further study on effect of female representation verses male representation in board of microfinance banks in Kenya.

It is also recommended that the Institute of Certified Public Secretaries in conjunction with AMFI come up with awards to those banks that practice best corporate governance to encourage and root the culture of corporate governance adoption in MFBs in Kenya.

The regulator should ensure that all corporate governance disclosures as stipulated in the act and Microfinance Regulation (2008) are fully followed, implemented and made in the annual reports. In addition, the regulators should also improve on the mechanisms of ensuring that the corporate governance disclosures in the annual reports are not simply statement of good intentions but are actually implemented at firm level. This will greatly improve the level of corporate governance adoption, implementation and by extension firm performance.

5.5 Limitations of the Study

While the findings of this research are important, they invariably suffered from several limitations. No research can be comprehensive and this research addresses only some elements of corporate governance and is restricted to microfinance banks in Kenya.

The main limitation of the study was that the data was collected through publicly available data sources such as annual reports mainly from the Central Bank of Kenya. If there were any problems relating to data disclosures or professional accounting practices, then that would limit the validity of the findings.

The research used only three variables of corporate governance of MFBs in the model yet there are many other alternative measures that may have provided different results from the ones provided by the variables used. There were also limited disclosures on corporate governances practices related to board structure and composition. Some disclosures on board meetings and composition were missing for 25% of the microfinance banks.

Time was also a limiting factor since the study was involving and required a lot of attention especially when gathering data. Therefore the information obtained represents that which was available within the limited time frame. Probably, the findings would have been different if time was available to gather more data.

5.6 Suggestions for Further Research

More studies should be done to ascertain the relationship between corporate governance practices and other aspects of performance such as social performance. More specifically studies should be done to establish the effect of CG practices on a combination of both social and financial performance given the fact that MFBs have a dual obligation or goal; to provide financial services to the poor and attain financial sustainability.

The inclusion of other corporate governance practices to increase the variables under study should be conducted to see if similar results can be obtained thus make a valid conclusion on effect of corporate governance on financial performance of MFBs in Kenya. Further, study should be conducted on specific corporate governance practices in relation to financial performance so as to get a detailed report on the effect of each variable independently.

Also the scope of future studies should be reduced maybe to one MFB so as to carefully scrutinize the effect of the corporate governance practices adopted by the MFB under study. Perhaps this would draw more insight on the financial performance.

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APPENDICES

Appendix 1: List of MFBs Licensed by CBK as at 31st December 2014

No.	Bank	Date licensed
1	Faulu Microfinance Bank Ltd	21st May 2009
2	Kenya Women Microfinance Bank Ltd	31st March 2010
3	Uwezo Microfinance Bank Ltd	8th November 2010
4	SMEP Microfinance Bank Ltd	14th December 2010
5	Remu Microfinance Bank Ltd	31st December 2010
6	Rafiki Microfinance Bank Ltd	14th June 2011
7	Century Microfinance Bank Ltd	17th September 2012
8	Sumac Microfinance Bank Ltd	29th October 2012
9	U&I Microfinance Bank Ltd	8th April 2013

Appendix 2: Descriptive Statistics

ROA

	2010	2011	2012	2013	2014
MEAN	-0.0089	-0.0409	-0.0028	-0.0217	-0.0137
MAX	0.0161	0.0136	0.0248	0.0188	0.0193
MIN	-0.0338	-0.1289	-0.0490	-0.1671	-0.1727
STDV	0.0353	0.0621	0.0261	0.0584	0.0623

BDS

	2010	2011	2012	2013	2014
MEAN	7.5000	8.0000	8.1667	8.0000	8.8889
MAX	10.0000	12.0000	12.0000	11.0000	14.0000
MIN	5.0000	5.0000	6.0000	6.0000	6.0000
STDV	3.5355	2.5298	2.3166	1.8708	3.1402

Proportion of NEDS

	2010	2011	2012	2013	2014
MEAN	0.7500	0.8922	0.8644	0.9094	0.9241
MAX	0.6000	1.0000	1.0000	1.0000	1.0000
MIN	0.6750	0.7143	0.7143	0.7000	0.7500
STDV	0.7500	0.1317	0.1216	0.1144	0.0976

BDG

	2010	2011	2012	2013	2014
MEAN	0.5000	0.2893	0.2837	0.2422	0.2188
MAX	0.8000	0.7500	0.7500	0.7000	0.5833
MIN	0.2000	0.1111	0.1111	0.0000	0.0000
STDV	0.4243	0.2330	0.2360	0.2336	0.2045

Total Assets

	2010	2011	2012	2013	2014
MEAN	11,645,697,425	4,133,041,858	5,401,686,117	4,592,740,333	6,330,170,684
MAX	18,958,394,000	17,035,785,000	20,384,438,000	21,752,092,000	26,984,912,000
MIN	4,333,000,850	58,668,791	78,609,470	80,186,389	137,245,654
STDV	10,341,714,674	6,608,437,789	7,841,557,543	7,562,562,234	10,137,863,425

Appendix 3: Research Data

Banks	Year	ROA	BDS	BDI	BDG	Total Assets
	2010	-0.0338	5	0.6000	0.2000	4,333,000,850
	2011	-0.0026	7	0.7143	0.2857	5,140,576,000
	2012	0.0091	7	0.7143	0.2857	7,637,676,000
	2013	0.0165	6	0.8333	0.3333	12,419,216,000
Faulu	2014	0.0183	12	0.8333	0.1667	20,319,958,000
	2010	0.0161	10	0.7500	0.8000	18,958,394,000
	2011	0.0136	12	0.7500	0.7500	17,035,785,000
	2012	0.0093	12	0.7500	0.7500	20,384,438,000
	2013	0.0188	10	0.7000	0.7000	21,752,092,000
KWFT	2014	0.0187	12	0.7500	0.5833	26,984,912,000
	2011	0.0130	6	1.0000	0.1667	1,998,220,000
	2012	0.0248	6	1.0000	0.1667	2,289,510,000
	2013	0.0023	6	1.0000	0.1667	2,490,447,000
SMEP	2014	-0.0399	6	1.0000	0.1667	2,378,138,000
	2011	-0.0349	5	1.0000	0.2000	440,661,000
	2012	0.0044	6	0.8333	0.1667	1,838,191,000
	2013	0.0034	6	0.8333	0.1667	3,678,751,000
Rafiki	2014	0.0043	6	0.8333	0.1667	5,975,126,000
	2011	-0.1057	9	1.0000	0.2222	124,340,354
	2012	-0.0490	9	1.0000	0.2222	181,692,231
	2013	-0.0229	9	1.0000	0.2222	336,680,526
REMU	2014	0.0081	14	1.0000	0.2857	394,547,604
	2011	-0.1289	9	0.8889	0.1111	58,668,791
	2012	-0.0156	9	0.8889	0.1111	78,609,470
	2013	-0.0281	11	0.8182	0.0909	106,668,818
Uwezo	2014	0.0088	10	0.9000	0.1000	160,156,758
	2013	0.0182	9	1.0000	0.0000	80,186,389
U & I	2014	0.0193	7	1.0000	0.0000	137,245,654
	2013	-0.1671	8	1.0000	0.5000	163,608,074
Century	2014	-0.1727	6	1.0000	0.5000	231,192,970
	2013	-0.0361	7	1.0000	0.0000	307,013,187
Sumac	2014	0.0120	7	1.0000	0.0000	390,259,168

Appendix 4: Financial Performance of MFBs for 2010-2014 Periods

Year	TOTAL ASSETS	% GROWTH IN ASSETS
2010	23,291,394,850	-
2011	24,798,251,145	0.0647
2012	32,410,116,701	0.3070
2013	41,334,662,994	0.2754
2014	56,971,536,154	0.3783