THE RELATIONSHIP BETWEEN BANK CORPORATE GOVERNANCE AND PERFORMANCE OF KENYAN BANKS.

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Research project submitted to the School of Economics, University of Nairobi, in Partial Fulfilment of the Requirement for the Degree of Master of Arts in Economics
DECLARATION

This research project paper is my original work and has not been presented for any partial fulfillment of award of degree in any other institution.

Signature: …………………… Date: ………………………………

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Reg. No X50/79133/2015

This research project has been submitted to the School of Economics, The University of Nairobi, with approval from the University supervisor.

Signature: …………………… Date: ………………………………

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I also extend my regard to my classmates, Elizabeth, Onesmus, Lenah and Bernard for their constant encouragement and support during the class work and project stages. I appreciate the input of Bernard and Kagecha on this project.
DEDICATION

I humbly dedicate this project to my late Grandfather and Grandmother who planted a seed of chasing dreams in me. I further dedicate it to my niece Joy Kathomi, my mentor Wallace and relatives and Man Enough members.
ABSTRACT
The agency theory proposes a large board size and a board dominated by non-executive directors. Studies have been done on data of companies in different sectors both in Kenya and outside. This study examined the relationship between corporate governance and performance of Kenyan banks. The study was motivated by the recent cases of banks collapse in Kenya for instance, Chase bank, Imperial bank and Dubai bank. The study employed panel data for the period 2008-2015, generalized method of moment (GMM) estimation technique was used in order to overcome the endogeneity problem. The empirical findings indicate that corporate governance variables, board size, and non-executive directors do not influence performance of Kenyan banks. The results of this study went ahead to establish that Kenyan banks corporate governance practices are not at par with each other. Market risk and business risk factors do not influence adoption of corporate governance practices in Kenyan banks.
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ACRONYMS

AR (1): First order Auto correlation

AR (2): Second order Auto correlation

BHC: Bank Holding Company

CBK: Central Bank of Kenya

CEO: Chief Executive Officer

CCG: Center for Corporate Governance

CG: Corporate Governance

CMA: Capital Market Authority

EPS: Earning per Share

GMM: Generalized Method of Moments

KES: Kenya Shilling


NIM: Net interest margin

NSE: Nairobi Securities Exchange

OECD: Organization for Economic Cooperation and Development

OLS: Ordinary Least Square

ROA: Return on Assets

ROS: Return on Sales

ROI: Return on Income

ROE: Return on Net worth/Equity

2SLS: Two Stage Least Square
DEFINITION OF KEY TERMS

Executive Director: A member of the board of directors who is involved in the day-to-day operations of a company.

Non-Executive Director: A member of the board of directors who is not involved in the day-to-day management of a company.

Independent Director: A member of the board of directors who does not significant ownership interest in the company, holding company or subsidiaries or associated with the senior management or a significant customer or supplier.

Idiosyncratic Variables- Variables that are specific to a company.

Liquidity: Ability of meeting financial obligation when they arise.

Banking Group: A licensed institution and its subsidiaries, non-operating holding companies and subsidiaries of its non-operating holding companies.

Bank Holding Company: A company that owns and has approved control of an institution and whose activities are limited to holding investments in subsidiaries. Holds properties used by group members and ensures efficient operation of the group.

Subsidiary: A company having more than 50% of its stock owned by another company or an entity that is controlled by a company or by a non-operating holding company.
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CHAPTER ONE
INTRODUCTION

1.1 Background to the Study

The Great Depression of 1930s, the Great Inflation of the 1970s, the National Debt Crisis of the 1980s and the Great Recession of 2007-2008 are some of the major financial crisis that have plagued financial systems in the past. Since the 1930s till 1970s the Neoclassical-Keynesian synthesis was the basis for formulation of macroeconomic policy around the world. At the 1970s there was a paradigm shift and Neoliberalism replaced Neoclassical-Kenynesian as the basis for macroeconomic policy formulation. Neoliberalism comprised of Monetarists, Supply-Side Economics, New Classical and Neoclassical school of thoughts. Neoliberalism led to the effect of expanding levels of financialization within economies. The 2007-2008 Great Recession is viewed as the worst financial crisis among the major financial crisis. It threatened the collapse of large financial institutions, for example, Lehman Brothers and Goldman Sachs, in most cases it was prevented by bailout by national governments (Erkens et al., 2012). Collapse of financial institutions was connected to dramatic failures in corporate governance.

The idea of corporate governance has increasingly become a subject of topical interest especially when there is separation of ownership from control. This has been contributed by increased dispersion of share ownership across many shareholders. Corporate governance is a set of relationships between a company’s management, its board, its shareholders and other stakeholders. It provides the structures that outline the objectives and ways of attaining them while monitoring performance (OECD, 1999). Profitability is considered to be an indicator of performance, shareholders invest in profitable firms to get returns from their investments. Profitable firms generate capital gains as well as higher dividends.

Since high liberalization exist in financial markets, the financial systems are protected through regulation and supervision (Brownbridge and Colin, 2000). The banking sector is faced with information asymmetry problem that affects shareholders monitoring effects. The board of directors guides the firm’s strategic objectives and through monitoring of activities the interests of different parties are addressed.
1.1.1 Banking Sector in Kenya

The Companies Act, the Banking Act, the Central Bank of Kenya and the various prudential guidelines issued by CBK governs the banking industry in Kenya. A bank is a licensed company which carries on or has a proposal to carry on banking business in Kenya excluding the Central Bank (Banking Act of Kenya, 2015). This is both in Kenya and elsewhere. Banking business involves accepting money whether on deposit or current account from the public. This money is repaid when demanded, expiry of fixed period by customer or on notice. The banks use this money to lend to public or investing. The banks bear the risk on the use of the money from the members of the public (Banking Act of Kenya, 2015).

At independence Kenya was part of the East Africa Currency Board which supplied and controlled the currency of british colonies in East Africa from 1919 to 1966. The Central Bank of Kenya was established in 1966. The government policy of encouraging local participation in the financial system led to growth of banking institutions in the 1970 to 1990s. There were 10 banks as at 1969 and by December 1994 there were 36 banks operating in Kenya, that is over 70% growth (Bank Supervision Annual Report, 1994). In 1980s and 1990s the banking sector faced a crisis with many banks facing undercapitalization. This was contributed to weak monetary policy control by the CBK, weakness in prudential supervision and inadequate legal and regulatory framework for the financial system. The collapse was linked to financial repression since the developing countries operated on low interest rates aimed at increasing investment level (Ngugi and Kabubo, 1998).

Due to the massive collapse of banks in the 1980’s, the Deposit Protection Fund Board established in 1985. The fund was meant to protect depositors in the event of collapse of institutions contributing to the fund. Capital adequacy requirement was also increased by the CBK to 15M for banks and 7.5M for non-bank financial institutions in 1985. Inspection of financial institutions, capital adequacy requirements, establishment of reporting framework and auditing were enhanced by the CBK. Further, the CBK imposed stringent licensing requirements for banks. This was to enhance the CBK ability to supervise the Kenya financial system more effectively.

By December 2015, the Kenya banking sector comprised of 44 commercial banks, 12 Microfinance Banks (MFBs), 8 representative offices of foreign banks, 3 credit bureaus (CRBs),
15 Money Remittance Providers (MRPs) and 80 foreign exchange (forex) bureaus. Out of the 44 banking institutions 41 were privately owned while the other 3 the Kenya Government had majority share ownership. 27 of the privately owned banks were locally owned (the controlling shareholders are domiciled in Kenya) while 14 were foreign-owned. Of the 27 locally owned there were all commercial banks. (Central Bank Kenya Bank Supervision Annual Report, 2015).

**Figure 1: Bank Balance Sheet**

Source: Bianchi and Bigio 2013

Banks are faced with the liquidity management and portfolio risk management problem. Granting of a loan by bank simultaneously leads to creation of a demand deposit. Banks generate profits from issuing loans because they charge a higher interest rate than what they pay for deposits. When lending is more relative to central banks reserves the bank is exposed to liquidity risk. When deposits are withdrawn the bank’s reserves are also depleted and sometimes forced to borrow from central bank or other banks at an interest. This is costly and shrinks the balance sheet and affects profitability (Bianchi and Bigio, 2013). Risk management problem arises when managing the loan book. If banks have non-performing loans they are required to
provision and write off, this decreases profitability. Presence weak corporate governance on liquidity and portfolio risk management affects bank profitability.

1.1.2 Corporate Governance in Kenya

A Gazette Notice no. 3302 of 2002 guided the adoption of corporate governance practices applicable to listed companies in Kenya. The adoption of the guidelines is voluntary and firms are not legally bound. Firms are required to comply or explain the extent of non-compliance (Capital Markets Authority, 2002). Corporate governance outlines the structures for setting and achieving the goals of a company. Objectives are attained by adhering to corporate accounting catering for shareholders and other stakeholders (Capital Markets Authority, 2002).

Good corporate governance should set corporate objectives, running of day-to-day business considering the interest of all stakeholders. Protection of depositor’s interests and other creditors (Central Bank of Kenya Act, 2015). Sound corporate governance principles include for example, ethical leadership and integrity, responsibility to shareholders, responsibility of the board, role and competence of board members and corporate governance in a group structure (Central Bank of Kenya Act, 2015).

The CBK specifies the practices that are applicable to banks in operation in Kenya and well outlined in the prudential guidelines. These practices include constitution of board of directors, board committees and having directorship in more than two licensed institutions (CBK Prudential Report, 2006).

1.1.3 The Board of Directors

The Articles of Association under the Companies Act of Kenya (CAP 486) is the constitution guiding a company formation and the directors. The Companies Act of Kenya (CAP 486) of the Laws of Kenya state that for incorporation of a company two directors are the minimum. The CBK requires that institutions licensed by the Banking Act to have a minimum of five directors. The board should encompass a mix of executive and non-executive directors. To enhance independence the independent directors should be non-executive directors. The CEO of a bank should also be a board member. To enhance independence and objectivity; the independent directors are not supposed to be less than a third of the total board membership (Central Bank of Kenya Act, 2015).
The CBK Act, 2015 further specify the procedures on director appointments and individuals who are not eligible for appointment as directors. For example, professionals (lawyers, accountants and valuers) who offer the specific institutions professional services. Senior officials and individuals who are non-executive directors in a Government regulating body also don’t qualify for directorship because there may be a conflict of interest.

Board committees provide focused specialized experience and expertise to the board. This leads to optimal decisions by the board. The number and nature of board committees depend on the bank specific factors. The Board Audit Committee, Board Risk management Committee and Board Credit Committee are mandatory (Central Bank of Kenya Act, 2015). The composition of each committee is different in terms of objective, leadership and membership. For instance, the audit committee shall be made of independent directors.

Board meetings as provided by the CBK Act specify that it’s upon each director to attend meetings of the board in a regular manner. Every board member shall attend at least75% of board meetings of an institution in a financial year. Boards of Bank Holding Companies (BHC) are assigned similar responsibilities as other boards of single entity boards. A bank as a component of the Bank Holding system has its own board. BHC board’s structure must sync with subsidiary bank boards (Adams and Mehran, 2003). If subsidiary boards play a coordinating role then BHC structure is expected to be correlated with BHC board structure.

1.2 Statement of the Problem

The Kenya corporate governance system was influenced by the privatization and financial liberalization in the 1990s. Financial liberalization opened up the banking industry leading to increase in the number of banks. According to Bank Supervision Annual Report, 1994 by CBK banks grew from 10 as at 1969 to 36 in 1994, over 70% in growth. This led to competition which may have contributed to weak performance and collapse of some banks (Mwangi, 2002). To reduce chances of banks collapse due to governance problems the CBK issued prudential guidelines on bank corporate governance. Corporate governance in Kenyan banks is subject to question in view of the recent cases of banks in Kenya falling into liquidity problems leading to statutory management and some undergoing receivership for instance, Imperial bank, Dubai bank and Chase Bank.
Recent studies on corporate governance in Kenya is seen in the works of, Jebet, (2001); Oyoga (2010); Ongore et al., (2015); Otieno (2012); Chepkosgei 2013. Some of these studies have focused on data of many companies operating in different sectors. Studies on corporate governance and banks performance in Kenya were based on idiosyncratic variables. This study seeks to bridge the methodological gap by including market risk and business risk as explanatory factors. This study also empirically studied the banking sector to fill the gap on studies carried in different sectors. This study sought to address the following research questions; what are the corporate governance practices in Kenyan banks between 2010 and 2015? What are the effects of idiosyncratic corporate governance factors while controlling for market and business risks as explanatory factors and performance of Kenyan banks? What are the relevant policy implications based on findings?

1.3 Objectives of the Study

The main objective of this study is to empirically examine the relationship between corporate governance and performance of Kenyan banks.

Specific objectives:

i. To compare and contrast corporate governance practices by Kenyan banks between 2010 and 2015.

ii. To determine the relationship between idiosyncratic corporate governance factors while controlling for market and business risks and performance of Kenyan banks.

iii. To provide policy recommendations on the basis of findings of the study.

1.4 Significance of the Study

Considering banks are important financial intermediaries in most economies, it is important to understand their governance practices. Banks are heavily regulated and are supposed to disclose financial information uniformly. The banking system is composed of shareholders, management, customers and the regulator. The banking sub-sector of the financial system is well suited to study the corporate governance on firm performance.

This study will be significant mainly to banks on additional variables to establish the influence of various corporate governance practices on performance. This will aid in implementing and
monitoring corporate governance principles in the banking sector. This study will contribute to existing wealth of corporate governance literature by studying a specific sector because previous studies had concentrated on firms in different sectors. This study also examined if corporate governance had a role in the re-emergence of banks collapse in Kenya. The study findings will be useful for future research on this subject.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This chapter discusses the theoretical literature, empirical literature and an overview of the literature of the study.

2.2 Theoretical Literature Review
The theoretical literature review examined the theories that have been used to explain corporate governance. The theories are; Agency theory, Stewardship theory and Resource dependency theory.

2.2.1 Agency Theory
According to Berle and Means (1932) the idea of agency relationship was between shareholders and management. In their study they found existence of conflicting interests between the management and shareholders. They observed that the relationship was brought about by dispersed ownership of shares among many shareholders. The dispersed ownership had replaced the sole ownership of corporations which was in existence in most firms. They further extended the agency relationship from management and shareholders to bondholders and creditors. Berle and Means did not address the results of separation of management and shareholders. They further did not address the need for efficient monitoring upon separation of ownership from control.

Alchian and Demsetz (1972) observed the agency relationship as set of contracts in a firm. These contracts were made between the firm and other parties, for example, suppliers, creditors, debtors, management and shareholders. These parties formed contracts with the firm hence they were agents to the firm. The shareholders had the right to sell their shareholding at free will. They argued that the management had to be separated from shareholders hence supported agency relationships.

Jensen and Meckling (1976) extended the principal-agent relationship in terms of utility maximization. They held the view that managers who are the agents of shareholders may act against the shareholders’ interests. This is by attaining self-utility instead of achieving the shareholders goals. They regarded this as the agency problem. To solve this problem the
shareholders had to incur agency costs. The agency costs were in form of monitoring costs, hiring of directors and auditors. They argued that to align the management interest to shareholders’ interests the management was offered incentives. The incentives were in form of compensation packages and share options. These propositions by Jensen and Meckling in terms of share options have not been widely applied by modern corporations.

Fama and Jensen (1983) extended the agency problem in terms of costs involved in monitoring of management by shareholders. They went further to distinguish the agency relationships between private partnerships, financial and non-financial corporations and donor agency relationships. They also suggested that to monitor management, a larger proportion of outside directors would be important.

2.2.2 Stewardship Theory

The stewardship theory tries to reduce the level of conflict between management and shareholders as postulated agency theory. Donaldson and Davis (1991) argue that an executive of a corporation would want to carry out a task and provide good stewardship of the company’s assets. They further propose that for a high corporate performance a larger proportion of inside directors is preferred. For efficiency in decision making stewardship theory propose the position CEO and board’s chairman be occupied by different persons.

According to Davis, Schoorman and Donaldson (1997) views stewardship relationship when management is not driven by selfish interests but motivated by achieving the firms objectives. They argued that management gained more satisfaction attaining firm’s goals than their own desires. Most of the cases is not true. Muth and Donaldson (1998) argue that the manager acts as a steward and takes into consideration non-financial motives for managerial behavior. The manager will be driven by seeking recognition, satisfaction in successful achievement and honor of authority. They propose that a board made of more inside directors grants the company an edge in terms of knowledge, expertise, access to information and commitment to meet organizations objectives.

2.2.3 Resource Dependency Theory

This theory aims to reduce dependence between management who are in operational control and the board of directors who provide strategic control. Provision of resources to management aims
at reducing dependence on shareholders. Pfeffer and Salancik (1978) posit that interdependence is important for an organization to achieve its desired outcomes which depend on the availability of resources. They further argue that resource availability reduces the dependence between the different parties in need of them and to reduce the problem of resource uncertainty is by increased coordination.

According to Hillman and Thomas (2003), resource dependence examine how board capital which includes legitimacy, advisory and linking the firm to other organizations leads to provision of resources to the firm. Josiah et al., (2013) focused on how organizations try to control their locality by utilizing the resources for survival. They argue that the board of directors provide means through which resources are available in an organization and also offer linkages to the external environment.

2.3 Empirical Literature Review

This segment will discuss the empirical studies carried out, estimation techniques and findings on corporate governance and firm financial performance.

To examine if corporate governance has influence on firm performance Olawumi et al., 2015 studied companies listed in Nigeria Stock Exchange. The study adopted random effects regression model. Indicators of performance were ROA and ROE and proxies for corporate governance were board size, board independence, gender diversity and ownership structure. Findings of the study findings were that board size affects profitability negatively. Board independence, gender diversity and ownership structure does not influence profitability. However, the results could have been different when analysis is done for a specific sector in the economy.

Pearce and Zahra (1992) studied a sample of Fortune 500 companies to establish the relation between board’s composition and survival success, environment and past performance. The period examined was between 1983 and 1989. The proxies for firm performance were ROA, ROE, EPS and net profit margin. The board size and outside directors’ representation were the indicators of board composition. The study applied multivariate analysis of variance controlling
for firm size. The study results found that board size and outside director’s representation significantly influenced firm performance positively.

In the Kenyan literature, Ongore et al., 2015 wanted to establish if board of director’s composition influenced firm financial performance in 2011. They studied firms listed at NSE. The study applied Ordinary Least Square (OLS) as an estimation technique. The study used ROA, ROE and Dividend Yield as performance indicators and board size, independent board members and gender diversity as proxies for board composition. The conclusions of the study were that gender diversity significantly influenced performance. The study results also found that independent board membership did not significantly performance, board size was inversely influenced firm performance. This study by use of panel data eliminated the problem of multicollinearity. The results could have been different when analysis for a specific sector is done.

Kiel and Nicholson (2003) investigated Australian companies in 1996 to find the relationship between board of directors and company’s financial performance. Indicators of corporate performance used were Tobin’s Q and ROA, board size and ratio of outside directors represented composition of the board. The empirical results were that board size significantly influenced firm performance. Proportion of outside directors significantly influenced Tobin’s Q negatively and ROA was insignificant. The firm size had a positive relationship with ROA. The study had mixed findings on the performance measures. This study did not include banks in the analysis hence the results could be different if banks were included.

Al Matari et al., 2012 studied listed Kuwaiti firms to establish if firm financial performance was related to board of directors’ composition. Using CEO duality and tenure, size of the audit committee and size of the board as variables for board composition. They used ROA as a performance measure controlling for firm size and leverage. The study found CEO duality and tenure and size of the audit committee positively influenced performance. Board size had insignificant impact on performance. Leverage significantly influenced performance negatively and firm size had positive insignificant influence on performance. This study had eliminated banks which leaves a research gap.

they found out that the number of outside directors is higher, board size larger in bank holding companies than in manufacturing firms. They further established the boards of bank holding companies meet more frequently and this was anchored on subsidiaries of bank holding companies resulting on a wider scope.

To determine if corporate governance influence firm financial performance Kyereborah (2007), studied firms in four African countries. The period examined was from 1997 to 2001. Performance was estimated by ROA and Tobin’s Q. Board size, independence, board activity intensity, CEO being the board’s chairman, tenure of CEO, audit committee and degree of institutional ownership as proxies for corporate governance. The empirical results were that; board size, independence, CEO tenure, audit committee and how frequency they held meetings significantly influenced performance positively. Institutional ownership influenced market valuation of firms while CEO duality and board activity intensity influenced performance negatively. This study eliminated banking and finance sector creating a gap in the study.

Dalton et al., 1998 reviewed studies to determine if board composition influenced firm financial performance. The proxies for board composition were ratio of outside directors, and proportion of independent directors. They used market measures of firm financial performance and also accounting measures. Results from various studies established that board composition had no significant influence on performance.

To establish if board diversity influences firm value Carter et al., 2003 examined a sample of Fortune 1000 firms. The proxies for board diversity were proportion of women in the boards and minorities and used Tobin’s Q as dependent variable. The study conclusions were that female directors and minorities significantly influenced performance positively. Other empirical study with the same conclusion is by Erhardt et al., 2003 who estimated ROA and ROI as proxies for performance and ethnic and gender representation as indicators of board diversity. The study focuses on market based measure of firm performance.

Smith et al., 2005 established board of directors’ diversity influenced performance positively of Danish firms between 1993 and 2001. The study used fixed effects regression model. They operationalized performance measures in form of ratios which included, Gross value added/Net turnover, Profit on ordinary operations/net turnover, ordinary result/net assets and net profit/net
assets. This affirms an earlier study by Shrader et al., 1997 on United States firms. They findings of the study found women in management significantly influenced performance.

To establish if corporate governance impacted firm financial performance David Yermack (1996) carried a study using US industrial corporations for a period between 1984 and 1991. The study applied Ordinary Least Square (OLS) estimation technique. He used Tobin’s Q as performance measure and board size as proxy for corporate governance. Controlling for firm size, industry of a firm, board composition, inside shares ownership, company age the findings did not change. This study does not include utility and financial firms, inclusion of those firms could have altered the results of the study.

2.4 Overview of Literature Review

The theoretical and empirical literature shows that most studies have examined companies in developed economies. (Kiel and Nicholson, 2003; Pearce and Zahra, 1992; David Yermack, 1996; Smith et al., 2005; Shrader et al., 1997). Theoretically the agency theory supports the separation between shareholders and management (Berle and Means, 1932). The agency theory also proposes the existence of non-executive directors in the company (Fama and Jensen, 1983). The stewardship theory argues against the agency theory and proposes existence of majority inside directors in a company.

There are however a few studies (Olawumi et al., 2015 and Kyereborah, 2007 who did studies in less developed countries. Similarly majority of studies done corporate governance in Kenya focus on the idiosyncratic factors of firms (Jebet, 2001; Wanjiru, 2013; Ongore et al., 2015; Otieno, 2012; Chepkosgei, 2013). Some studies included firms in several sectors these include Ongore et al., 2015 and Al Matari et al., 2012. A study in a specific sector would provide more objective results. Some of the studies done in developed countries had eliminated banking sector in their study. This study intends to fill the empirical as well as the methodological gap since most studies did not consider the business and market risk factors.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This section described the theoretical framework of the study and the empirical model specification. It also presents definition and measurement of variables and sources of data.

3.2 Theoretical Framework
The theoretical framework for this study builds on the theoretical framework used by Olawumi et al., 2015. The framework will be based on agency theory. The agency theory supports where ownership is separated from control (Berle and Means 1932). The theory recognizes the existence of conflicting interests between the management and the shareholders. Since the shareholders provide the resources to management, to monitor the management the shareholders appoint the directors to represent interests of shareholders. The board of directors offers strategic control of resources and executive management operational control of resources.

Figure 3.1 Agency Relationship

![Agency Relationship Diagram]

Source Author
Firm performance = f (Market risk factors, Business risk factors, Idiosyncratic factors)………………………………………………………………………………………………3.1

Profitability of Bank = f (One-Period lagged profit, Board size, Bank size, Ratio of Non-Executive directors, Gender, Inflation, Central Bank Rate, Number of meetings) ..........3.2

Figure 3.2: Conceptual Framework

<table>
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<td><strong>Idiosyncratic Factors</strong></td>
<td>Return on Equity</td>
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<td>Board size</td>
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<td>Bank size</td>
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<td>Non-executive Directors</td>
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<td>Gender</td>
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<td>Number of Board Meetings</td>
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<td><strong>Market Risk Factor</strong></td>
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<td><strong>Business Risk Factor</strong></td>
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<td>Central Bank Rate</td>
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Source Author
3.3 Empirical Model specification

The empirical model is defined as shown below:

\[
\ln ROE_{it} = \beta_0 + \alpha \ln ROE_{i,t-1} + \beta_1 \ln \text{BOARDSIZE}_{it} + \beta_2 \ln \text{BANKSIZE}_{it} + \beta_3 \ln \text{NONEXCTIV}_{it} + \\
\beta_4 \ln \text{GENDER}_{it} + \beta_5 \ln \text{CPI}_{it} + \beta_6 \ln \text{CBR}_{it} + \beta_7 \ln \text{BOARDMEETING}_{it} + \varepsilon_{it} \]

Where:

\( \text{ROE}_{it} \) – The ROE of firm.

\( \text{ROE}_{i,t-1} \) – One year lag of ROE

\( \text{BOARDSIZE}_{it} \) – The board size

\( \text{BANKSIZE}_{it} \) – The bank size

\( \text{NONEXCTIV}_{it} \) – The ratio of non-executive directors

\( \text{GENDER}_{it} \) – Ratio of female directors

\( \text{CPI}_{it} \) – Proxy for log of CPI.

\( \text{CBR}_{it} \) – The Central Bank Rate.

\( \text{BOARDMEETING}_{it} \) – The number of annual board meetings.

\( \beta_j \), where \( j = 0, 1, 2, 3 \) these are unknown parameters to be estimated.

\( \alpha \) – Coefficient of the lagged ROE.

\( \varepsilon_{it} \) – Idiosyncratic disturbance term

In addition we note that \( i = 1 \ldots n \), the number of banks under study and \( t = 1 \ldots 6 \) since we are studying 2008-2015.

3.4 Definition and Measurement of Variables

3.4.1 Lagged Dependent Variable

The model will use a lag on dependent variable. Since the variable is endogenous OLS estimation is rendered inappropriate due to endogeneity bias. This study will use Return on
Equity (ROE) to measure bank profitability. ROE shows the returns to shareholders of a firm generated from their equity contribution. According to Ross et al (2003) ROE net income (after interest and tax) divided by shareholders’ equity. This study will use

\[
\text{ROE} = \frac{\text{Pre-tax Profit}}{\text{Shareholders' Equity}}
\]

3.4 Table 3.1 Summary of Variables and Measurements.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Description</th>
<th>Expected Sign</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board Size</td>
<td>Number of board members at the end of the financial year.</td>
<td>Positive</td>
</tr>
<tr>
<td>Bank Size</td>
<td>Size of Bank in terms of assets</td>
<td>Positive/Negative</td>
</tr>
<tr>
<td>Non-executive directors</td>
<td>The ratio of non-executive directors in the board of directors.</td>
<td>Positive/Negative</td>
</tr>
<tr>
<td>Gender</td>
<td>Ratio of female directors in the board</td>
<td>Positive/Negative</td>
</tr>
<tr>
<td>Inflation</td>
<td>Growth in Consumer Price Index (CPI)</td>
<td>Negative</td>
</tr>
<tr>
<td>Central Bank Rate</td>
<td>Rate of interest that the CBK charges on loans to banks.</td>
<td>Negative</td>
</tr>
<tr>
<td>Number of annual Board Meetings</td>
<td>Annual board meetings.</td>
<td>Positive/Negative</td>
</tr>
</tbody>
</table>

3.5 Estimation Procedure

This study used a balanced panel data for the period 2008-2015 of Kenyan commercial banks. Panel data is preferred since it combines both time series and cross sectional data hence expected to give unbiased estimators. This study adopted dynamic panel data model over static model. The reason is that static model eliminates lag of dependent variable in the regressors. Dynamic model suffers from biased and inconsistent estimates. OLS will be inconsistent and biased since the lagged variable will be correlated with the error term. The fixed effects (FE) estimator too will be biased because of the correlation existing between lagged variable and the previous period’s error term. FE consistency depends on T being large. The above problems can be overcome by use of GMM estimation.

This study employed the Generalised Method of Moments (GMM) technique which was proposed by Arellano and Bond, (1991). As a result of small size of T in our study we took into
consideration criticism by Arellano and Bover, (1995) and Blundell and Bond, (1998) that the estimator is inefficient if the instruments used are weak. In this regard we adopted the System GMM proposed by (Blundell and Bond, 1998). Unobserved heterogeneity is then controlled. It is derived by estimation of two equations, one in levels using lagged first differences as instruments whereas the second in first difference and using lagged levels as instruments. Two step system GMM estimator was used because the one step estimation assumes homoscedastic errors implying that it’s less efficient than the two step estimation.

We conducted a Sargan-Hansen test to determine over identification of restrictions will confirm if the instruments used are valid. The null hypothesis is that instruments are valid if asymptotically distributed as $\chi^2 (k)$ having degrees of freedom equivalent to instruments employed less the parameters that have been estimated. Finally we run a serial correlation to confirm satisfaction of Arrelano and Bond orthogonality conditions. The Null hypothesis there is zero second order autocorrelation in first differences equation residuals. Thus, rejecting it means there exists no autocorrelation in error terms.

3.6 Data Sources

This study will employ secondary data for the period 2008 to 2015 of Commercial banks in Kenya. The study will not include Housing Finance since it converted to a bank in 2015. The sources of data will include; Central Bank of Kenya, Nairobi Securities Exchange, Kenya Bureau of Statistics (KNBS), Capital Market Authority (CMA) and specific banks in Kenya under study. Data on will be extracted from published audited annual reports of banks in Kenya.
CHAPTER FOUR
EMPIRICAL RESULTS AND DISCUSSION

4.0 Introduction

In this chapter we present empirical findings of the Study. This includes descriptive statistics, a correlation matrix and the data regression results.

4.1. Descriptive Statistics

In Table 2 we discuss the summarized statistics for the variables employed in the study. ROE averaged 23.9% with about 11.8% standard deviations in reflection of high divergence in performance by individual banks. Corporate governance practices by individual Kenyan banks also show high divergence. The board size ranges from 5 to 10 which meets the CBK requirement of minimum of five board members as a practice of corporate governance. There is also high divergence in board meetings, gender and executive directors. This indicates the different corporate governance practices by Kenyan banks. ROE ranges from -17% to approximately 49% with a median of 26% and a mean of 24% implying that a few observations fell above the mean while a majority of observations were clustered below the mean. The positive average ROE is an indicator that Kenyan banks are fairly profitable. This is consistent with Ongore et al., 2015 who established positive average ROE in their study on corporate governance and Kenya banks performance.

Table 4.1: Summary Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Notation</th>
<th>Obs</th>
<th>Mean</th>
<th>Std Dev</th>
<th>Median</th>
<th>Max</th>
<th>Min</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity</td>
<td>ROE</td>
<td>144</td>
<td>0.2385</td>
<td>0.1182</td>
<td>0.26</td>
<td>0.49</td>
<td>-0.17</td>
</tr>
<tr>
<td>Bank Size</td>
<td>BANKSIZEE</td>
<td>144</td>
<td>95.780</td>
<td>93.1631</td>
<td>62.382</td>
<td>467.741</td>
<td>3.705</td>
</tr>
<tr>
<td>Board Size</td>
<td>BOARDSIZE</td>
<td>144</td>
<td>9</td>
<td>2.2048</td>
<td>10</td>
<td>14</td>
<td>5</td>
</tr>
<tr>
<td>Non-Executive</td>
<td>NONEXCTIV</td>
<td>129</td>
<td>2</td>
<td>1.9070</td>
<td>2</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Gender</td>
<td>GENDER</td>
<td>129</td>
<td>1</td>
<td>1.2868</td>
<td>1</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Number of Board</td>
<td>BOARDMEE</td>
<td>144</td>
<td>7</td>
<td>4.1734</td>
<td>5</td>
<td>33</td>
<td>4</td>
</tr>
<tr>
<td>Inflation</td>
<td>CPI</td>
<td>144</td>
<td>125.4835</td>
<td>22.5703</td>
<td>126.85</td>
<td>159.6</td>
<td>92.362</td>
</tr>
<tr>
<td>Central Bank Rate</td>
<td>CBR</td>
<td>144</td>
<td>9.6169</td>
<td>2.8068</td>
<td>8.865</td>
<td>16.5</td>
<td>6.54</td>
</tr>
</tbody>
</table>
4.2 Correlation Analysis

Table 4.2 shows the pair wise correlation matrix. Presence of correlation among regressors brings the risk of coming up with inaccurate estimates. This is because multi-collinearity affects the predictors as a result of inflated coefficient of standard errors, Gujarati (2004). To affirm the absence of multi-collinearity the coefficient of correlation should be less than 0.8. There exists positive correlation between bank profitability (ROE) and banks size (BANKSIZE), board size (BOARDSIZE and gender (GENDER). When the bank size increases the level of profitability increases. As board size increases there is more monitoring which leads to better corporate governance practices increasing a bank’s profitability. However, ROE and ratio of non-executive directors, board meetings (BOARDMEETING), inflation (CPI) and Central Bank Rate (CBR) are negatively correlated. Presence of non-executive directors reduces performance because of bureaucracy in decision making. Banks are negatively affected by a rise in CBR which means it would be costly to borrow funds from the CBK. Banks too are negatively affected by increase in price levels which affects their profitability because loans become more expensive for customers and there are high chances of Non-performing loans.

Table 4.2: Pair wise Correlation Matrix

<table>
<thead>
<tr>
<th>Variable</th>
<th>ROE</th>
<th>BANKSIZE</th>
<th>BOARDSIZE</th>
<th>NONEXCTIV</th>
<th>GENDER</th>
<th>BOARDMEETING</th>
<th>CPI</th>
<th>CBR</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROE</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BANKSIZE</td>
<td>0.5128</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BOARDSIZE</td>
<td>0.1887</td>
<td>0.5398</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NONEXCTIV</td>
<td>-0.3704</td>
<td>0.1452</td>
<td>-0.1137</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENDER</td>
<td>0.1999</td>
<td>0.5792</td>
<td>0.5996</td>
<td>-0.0694</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BOARDMEETING</td>
<td>-0.2448</td>
<td>0.2902</td>
<td>0.1068</td>
<td>0.0692</td>
<td>0.1413</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI</td>
<td>-0.1565</td>
<td>0.0073</td>
<td>0.2957</td>
<td>-0.0547</td>
<td>0.1570</td>
<td>-0.0367</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>CBR</td>
<td>-0.0268</td>
<td>0.0233</td>
<td>0.0669</td>
<td>-0.0857</td>
<td>0.0259</td>
<td>0.0672</td>
<td>0.3023</td>
<td>1</td>
</tr>
</tbody>
</table>

4.3. Estimation results and discussion

This study sought to determine the statistical relationship between corporate governance and performance of Kenyan banks. Looking at the estimated equation it fits the model pretty well as confirmed by the F test. This test has a value which is less than 5% hence we reject the null hypothesis coefficients do not equal zero in the regression. The Hansen J test is a test for over-
identifying restrictions. It has a p-value which is more than 0.05 hence we fail to reject the null hypothesis that the instruments as a group are exogenous. This validates the choice of our instruments. We have included AR (1) and AR (2) but our major interest is on AR (2) which detects autocorrelation in levels. It tests if orthogonality conditions by Arrelano and Bond are met. The null hypothesis is there exists no autocorrelation and in our study we found a p-value of above 5% therefore confirming the orthogonality conditions by Arrelano and Bond (1991). For this reason we fail to reject the null hypothesis.

The dynamic nature of our model is confirmed by high speed of adjustment. A coefficient of 0.49 implies that Kenyan banks conform to corporate governance practices and this is confirmed by a study by Chepkosgei (2013). Corporate governance principles outlined by CBK and CMA also may have contributed to adoption of corporate governance practices. Jebet (2011) confirmed the adoption by studying listed firms at NSE in Kenya.
Table 4.3: Two-step system GMM estimation results (dependent variable: ROE)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Notation</th>
<th>Value (t-stat)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lagged ROE</td>
<td>( \text{ROE}_{t-1} )</td>
<td>0.489* (2.09)</td>
</tr>
<tr>
<td>Board size</td>
<td>( \text{BOARDSIZE} )</td>
<td>-0.166 (-0.46)</td>
</tr>
<tr>
<td>Bank size</td>
<td>( \text{BANKSIZE} )</td>
<td>0.187** (2.23)</td>
</tr>
<tr>
<td>Gender</td>
<td>( \text{GENDER} )</td>
<td>-0.185 (-1.71)</td>
</tr>
<tr>
<td>Non-executive directors</td>
<td>( \text{NONEXCTIV} )</td>
<td>0.354 (-1.13)</td>
</tr>
<tr>
<td>Number of meetings</td>
<td>( \text{BOARDMEETING} )</td>
<td>-0.260** (-2.19)</td>
</tr>
<tr>
<td>Inflation</td>
<td>( \text{CPI} )</td>
<td>-0.518* (-1.78)</td>
</tr>
<tr>
<td>Central Bank Rate</td>
<td>( \text{CBR} )</td>
<td>-0.136 (-0.93)</td>
</tr>
<tr>
<td>F-test</td>
<td>( F(8,14)= 8.59 )</td>
<td>Prob(F)=0.000</td>
</tr>
<tr>
<td>Hansen J</td>
<td>( \chi^2(8) = 81.39 )</td>
<td>Prob&gt;chi2=0.114</td>
</tr>
<tr>
<td>AR(1)</td>
<td>( z = -1.71 )</td>
<td>p-value = 0.081</td>
</tr>
<tr>
<td>AR(2)</td>
<td>( z = 0.00 )</td>
<td>P-value = 0.999</td>
</tr>
</tbody>
</table>

This Table presents estimations using System GMM estimation. Significance levels at the 10%, 5%, and 1% level is denoted by *, ** and *** respectively.

The study findings show that the coefficient of board size of Kenyan banks is negative and statistically insignificant. This implies the board size does not influence ROE of Kenyan banks. This confirms the study done by Al Matari et al., 2012 on listed non-financial Kuwaiti firms that board size did not influence performance significantly. Further, these results confirm the findings.

Presence of non-executive directors in the board is negative but not statistically significant. This implies that any additional non-executive director in the board does not influence performance. This confirms the study by Olawumi et al., 2015 on companies listed in Nigeria Stock Exchange that board independence does not influence profitability.

Presence of female directors in the board is negative and statistically insignificant. Gender representation has no influence in the level of performance of Kenyan banks. These results do not confirm the studies by Ongore et al., 2015, Carter et al., 2003 and Smith et al., 2005 who established gender representation had significant influence on performance. The frequency of annual meetings by the board had a negative and significant relationship with bank performance. This implies if annual meetings increase the lower the performance. A board that meets frequently indicates the hardship in monitoring and attaining a firm’s objectives hence weak corporate governance.

On the bank size, there is a positive and significant relationship with bank performance. This implies that the bigger the size of the bank the more it adheres to good corporate governance practices. This is because the banks have to realize returns to the shareholders using the outlined governance practices. These results confirm the study by Kiel and Nicholson (2003) on a study on companies in Australia.

Turning to business risk and market risk conditions the study findings indicate that the CBR rate and inflation are negative and statistically insignificant. This implies that practice of corporate governance by Kenyan banks is not influenced by CBR or inflation. This is because some of the corporate governance guidelines have been outlined by the CBK and CMA for the listed banks. Further, adoption of corporate governance practices is voluntary as per the CMA (Capital Markets Authority, 2002).
CHAPTER FIVE

SUMMARY, CONCLUSIONS AND POLICY IMPLICATIONS

5.0 Introduction

The main objective of this study was to empirically examine the relationship between corporate governance and performance of Kenyan banks. The study considered corporate governance variables, a bank specific variable, business risk and market risk variable. The study used a dynamic panel data of commercial banks in Kenya spanning from 2008-2015.

5.1 Summary of findings

Results from the estimation are contrary to the agency theory which proposes a larger board size and presence of non-executive directors in the board. From the findings board size and presence of non-executive directors in the board does not influence performance of Kenyan banks. Gender representation in the board also does not affect performance of Kenyan banks. However, as the annual meetings increase performance declines. The bank size influences performance in a positive and significant manner. This implies banks in Kenya that have a larger asset base perform better financially. Considering the market and business risks they do not influence the corporate governance practices by Kenyan banks. Qualitatively the corporate governance practices are not uniform, the number of board meetings, board size, gender representation and non-executive directors differ across banks.

5.2 Conclusion

From the findings of the study we have established that gender, board size, non-executive directors as corporate governance variables do not influence performance. On the other hand, we have established that when annual board meetings increase there is as decline in performance. Bank size positively influences performance. Market and business risk factors have no influence on adoption of corporate governance practices.
5.3 Policy Implication

The research results have implications for both the bank management and the policy makers. Since board size is insignificant in determining performance, banks should come up with an optimal number of board sizes. The regulator should ensure the optimality of the board size to facilitate efficiency in decision making. The board’s composition should be such that the contribution of the board members is felt in terms of gender and capacity, for example non-executive directors. The number of board meetings should reflect increased performance.

5.4 Areas for further research

This study findings indicate that several variables of corporate governance do not influence financial performance but further studies needs to be done by incorporating market value measures of performance. Additionally, inclusion of more variables of corporate governance which have been left out in this study should be included in further research.
REFERENCES


Available: http://www.centralbank.go.ke


## Appendix 1: Summary of Collapse of Banks in Kenya

<table>
<thead>
<tr>
<th>NAME OF BANK</th>
<th>MONTH AND YEAR OF COLLAPSE</th>
<th>REASON FOR COLLAPSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chase Bank Limited</td>
<td>April 2016 (Under CBK Management)</td>
<td>Liquidity difficulties, stepping down of directors.</td>
</tr>
<tr>
<td>Imperial Bank Limited</td>
<td>October 2015</td>
<td>Unsound business conditions.</td>
</tr>
<tr>
<td>Dubai Bank Kenya Limited</td>
<td>August 2015</td>
<td>Liquidity and capital deficiencies.</td>
</tr>
<tr>
<td>Charter House</td>
<td>June 2006</td>
<td>Money Laundering</td>
</tr>
<tr>
<td>Euro Bank</td>
<td>February 2003</td>
<td>Liquidity difficulties</td>
</tr>
<tr>
<td>Daima Bank</td>
<td>2003</td>
<td>Failure to meet capital adequacy levels.</td>
</tr>
<tr>
<td>Dephis Bank Limited</td>
<td>2001</td>
<td>Mismanagement</td>
</tr>
<tr>
<td>Trust Bank</td>
<td>1999</td>
<td>Insider lending to directors and shareholders.</td>
</tr>
<tr>
<td>Fortune Bank</td>
<td>1998</td>
<td>Poor management</td>
</tr>
<tr>
<td>Prudential Bank</td>
<td>1998</td>
<td>Liquidity problems</td>
</tr>
<tr>
<td>City Finance Bank</td>
<td>1998</td>
<td>Undercapitalization</td>
</tr>
<tr>
<td>Bullion Bank</td>
<td>1998</td>
<td>Insider loans (Unsecured)</td>
</tr>
<tr>
<td>Reliance Bank</td>
<td>1998</td>
<td>Mismanagement</td>
</tr>
<tr>
<td>United Bank Limited</td>
<td>1994</td>
<td>Undercapitalization, failure to observe cash and liquidity ratios.</td>
</tr>
<tr>
<td>Thabiti Finance</td>
<td>1994</td>
<td>Unsecured advances to directors and shareholders.</td>
</tr>
<tr>
<td>Diners Bank</td>
<td>October 1993</td>
<td>Undercapitalization</td>
</tr>
<tr>
<td>Nairobi Finance</td>
<td>April 1993</td>
<td>Disagreement among shareholders and undercapitalization</td>
</tr>
<tr>
<td>Middle Africa</td>
<td>August 1993</td>
<td>Undercapitalization</td>
</tr>
<tr>
<td>Trade Bank</td>
<td>August 1993</td>
<td>Undercapitalization</td>
</tr>
<tr>
<td>Central Finance</td>
<td>April 1993</td>
<td>Lending of unsecured loans mainly to shareholders and directors</td>
</tr>
<tr>
<td>Trade Finance</td>
<td>August 1993</td>
<td>Credit concentration to group companies.</td>
</tr>
<tr>
<td>United Trustee</td>
<td>April 1993</td>
<td>Insider loans (Unsecured)</td>
</tr>
<tr>
<td>Inter African Credit</td>
<td>June 1993</td>
<td>Unsecured advances to directors and shareholders.</td>
</tr>
<tr>
<td>Bank Name</td>
<td>Date</td>
<td>Reason</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>------------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Exchange Bank</td>
<td>September 1993</td>
<td>Persistent violation of Banking and CBK Act</td>
</tr>
<tr>
<td>Allied Credit</td>
<td>August 1993</td>
<td>Undercapitalization</td>
</tr>
<tr>
<td>International Finance</td>
<td>April 1993</td>
<td>Heavy reliance on parastatal deposits</td>
</tr>
<tr>
<td>Pan African Finance</td>
<td>October 1993</td>
<td>Persistent violation of Banking and CBK Act</td>
</tr>
<tr>
<td>Post Bank Credit</td>
<td>May 1993</td>
<td>Malpractices in the clearing house</td>
</tr>
<tr>
<td>Kenya Savings and Mortgages</td>
<td>December 1989</td>
<td>Insolvency, liquidity problem</td>
</tr>
<tr>
<td>Jimba Credit</td>
<td>December 1989</td>
<td>Borrowing ‘short’ and lending ‘long’ (mismatch)</td>
</tr>
<tr>
<td>Union Bank</td>
<td>December 1989</td>
<td>Mismanagement, poor credit policies</td>
</tr>
<tr>
<td>Nation Wide Finance</td>
<td>December 1989</td>
<td>Poor credit policies and insider lending</td>
</tr>
<tr>
<td>Home Savings and Mortgages</td>
<td>December 1989</td>
<td>Ineffective board of directors.</td>
</tr>
<tr>
<td>Estate Finance</td>
<td>December 1989</td>
<td>Adverse dominance and influence on the board of directors.</td>
</tr>
<tr>
<td>Business Finance</td>
<td>December 1989</td>
<td>Poor asset quality.</td>
</tr>
<tr>
<td>Capital Finance</td>
<td>December 1986</td>
<td>Ineffective board and management</td>
</tr>
<tr>
<td>Continental Bank of Kenya Limited and Continental Credit Finance</td>
<td>August 1986</td>
<td>Poor lending practices.</td>
</tr>
<tr>
<td>Rural Urban Credit and Finance</td>
<td>December 1984</td>
<td>Directors interference into day to day operations of the bank.</td>
</tr>
</tbody>
</table>