CHALLENGES FACING THE IMPLEMENTATION OF PERFORMANCE CONTRACTING AS A STRATEGY AT NATIONAL BANK OF KENYA

BY

SYLVIA CHEROTICH KOECH

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI

NOVEMBER 2012

DECLARATION

This research project is my original work and it has not been presented for examination to any other University.

Signed:___________________________ Date:__________________________

SYLVIA CHEROTICH KOECH

D61/8865/2006

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

Signed:____________________________ Date:__________________________

DR. JOHN YABS

LECTURER,

SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI

ACKNOWLEDGEMENTS

I would like to extend my sincere gratitude to the staff of National Bank of Kenya whom I interviewed for the support and information they provided to me. My appreciation also goes to my supervisor, Dr. John Yabs for his guidance and support during the preparation of my proposal.

I would also like to thank all the members of my family, who are not depriving me of their care and support during my studies. I am especially grateful to my mother Eunice Koech, without your prayers and support I would not be here today.

Lastly I thank Almighty God as my source of all inspiration in allowing me to undertake this project that is very involving in terms of time and resources.

DEDICATION

I dedicate this project to the late Mr. Joel Koech & Mrs. Eunice Koech for their continued support throughout my education and in all my undertakings. I wish to also dedicate My study is loving family and friends for their support, encouragement, and patience during the entire period of my study.

Thank you and God bless you abundantly

ABSTRACT

Performance contracting both in public and private sector is aimed at improving efficiency and effectiveness in the management of the organization's affairs. However, while this concept seems to work in many organizations in others it has been seen to fail either at the introduction or implementation stage. Therefore the purpose of this study is to assess the challenges facing the implementation of performance contracting as a strategy at National bank of Kenya. The researcher intended to establish the challenges facing the implementation of performance contracting.

The study adopted descriptive research design. The study utilized both primary and secondary data where Primary data was collected through interview guides while secondary data was gathered from various authoritative sources including books, published articles, and on-line journals. The findings were presented through discussions.

The study established that the challenges were discussed according to the study themes. The study found out that there is a monitoring and evaluation mechanism put in place to provide feedback on employee performance. This was done through semi-annual reviews on targets which have been deliberately designed to have measurable indicators. The review mechanism involves the employee, an appraising supervisor, a HR reviewer and finally a HR committee.

Among the many recommendations, the key recommendations from the study are that the bank should provide adequate resources to determine optimal level of resources and develop clearly defined targets for all functional units.

TABLE OF CONTENTS

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Organizations operate within a set environment and thus environment dependant and serving they cannot thus isolate themselves, whether private, public, profit or not for profit, (Ansoff, 1965). Organizations get raw materials, labour, entrepreneurship and consumers of their products from the environment. And so, fulfilling organizational mandate owners manage the operations in the short-run since they are small in size, simple structured and with matching simplified strategies. However as they grow and expand they become complex. It is at such a time that they engage the services of independent persons with relevant expertise and skills to run operations objectively. As the owners entrust the operations of the organization to external persons, they should have a way of setting performance targets together with their agents. This is performance contacting.

Strategic management is a field that deals with the major intended and emergent initiatives taken by managers on behalf of owners, involving utilization of resources, to enhance the performance of the firms in their internal and external environments (Hambrick, 1981) It entails specifying the organization's mission, vision and objectives, developing policies and plans, often in terms of projects and programs, which are designed to achieve these objectives, and then allocating resources to implement the policies, plans, projects and programs.

Performance contracting has been embraced by many organizations both in private and public sector. In the banking industry in Kenya many banks are on this mode as a strategy. Bank such as Barclays Bank of Kenya, Equity Bank, Family Bank and National Bank of Kenya have embraced this strategy in a bid to enhance and measure performance. National Bank of Kenya's performance contracting was sanctioned by the board of directors in 2008 (NBK board paper 2008). NBK operates as a quasi state agency with major government decisions being approved by government through the Permanent Secretary at Treasury. This has not gone on without any challenges.

1.1.1 Concept of Strategy

Strategic management provides overall direction to the enterprise which is still evolving as new paradigms are sought and the pendulum swinging every now and then. Generally organizations seek to strategically align themselves in the environment while others go for strategic consistency. Strategic management is the deliberate scanning of the environment and creating strategies that fit the organization to the environment, implementing the strategies and continuously reviewing their efficiency. According to Arieu (2007), there is strategic consistency when the actions of an organization are consistent with the expectations of management, and these in turn are with the market and the context. Strategic management includes not only the management team but can also include the Board of Directors and other stakeholders of the organization. There are many concepts that exist in strategic management including strategic planning, entrepreneurship, performance management, and performance contracting among many others.

An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents. According to Kleiman, (1999), agency relationships in various sectors, including those (1) between stockholders and managers and (2) between debt holders and stockholders (3) governments and their ministries departments and public agencies among many others.

Since central government cannot carry out core service provision functions effectively and efficiently various agencies have to be set up do so. Such agencies exist to deliver services in sectors including energy, health, water, banking, wildlife, mining agriculture among others. An agency relationship therefore exists between the government and its agencies.

1.1.2 Performance Contracting

The aim of performance contracting both in public and private sector is aimed at improving efficiency and effectiveness in the management of the organization's affairs. In the public sector, governments use performance contracting in the wider reform process to improve public administration and service delivery to the people while in private sector such contracts are used to measure exact performance of individual staff as well as the entire organizations, (Larbi, 2001).

Performance contracts are set out and signed at board levels and cascaded downwards to all employees of the organization who should all work towards achievement of the wider goals of the entire organization. The contracts outline specific outcomes expected within certain timelines outlined in the contracts.

However while this concept seems to work in many organizations in others it has been seen to fail either at the introduction or implementation stage. Trivedi (1990a) pointed out that the problems inhibiting the performance of government agencies have been identified as: excessive controls, multiplicity of principals with multiple and sometimes conflicting objectives, frequent political interference, poor management and outright mismanagement.

A Performance Contract is a freely negotiated performance agreement between the principal, and the management of the agency. It clearly specifies the intentions, obligations and responsibilities of the two contracting parties. A performance contract constitutes a range of management instruments used to define responsibilities and expectations between parties to achieve mutually agreed results. It is a useful tool for articulating clearer definitions of objectives and supporting innovative management, monitoring and control methods and at the same time imparting managerial and operational autonomy to public service managers.

1.1.3 Overview of the Banking Industry in Kenya

The banking industry in Kenya is governed by the Companies' Act, the Banking Act, the Central Bank of Kenya Act and various prudential guidelines issued by the Central Bank of Kenya (CBK). The Banking Act (2004) defines a bank as a company, which carries on or, proposes to carry on, banking business in Kenya and includes Co-operative Bank of Kenya but does not include Central Bank of Kenya. There are 43 commercial banks most of which are small to medium sized. Thirty of these are locally owned while 13 are foreign owned. The Locally owned banks comprise of three banks with significant government shareholding i.e. Consolidated Bank of Kenya, 77.8%; Development Bank of Kenya, 100% and national Bank of Kenya, 70.6%, (CBK, 2012). The industry is however dominated by large banks most of which are foreign owned though some are partially locally owned. Ten of the major banks are listed in the Nairobi Stock Exchange. (NSE, 2012)

The number of commercial banks decreased from 49 in June 2001 to 46 by June 2002. This followed liquidation of one bank, merger of two banks and a take-over of another. Non-bank financial institutions (NBFIs) declined to five in June 2002 form seven in June 2001 as two institutions merged with their parent banks (CBK 2002). The banking sector continued to be dominated by eight commercial banks, which accounted for 72.1% of the total assets and 72.5% base. Among the NBFIs, one institution with assets worth over Kshs.5bn dominated the sector and accounted for 62.0% of the total assets. The number of foreign exchange bureaus increased from 47 in June 2001 to 48 as at the end of June 2002 after the re-opening of an institution that previously closed. The moratorium on the licensing of new foreign exchange bureaus imposed in October 1999 was, however, still in force (CBK, 2002).

At the end of June 2003, the banking system comprised 43 commercial banks, 2 non-bank financial institutions (NBFIs), 2 mortgage finance companies and 4 building societies. Banking and non-banking financial institutions declined to 51 in June 2003 from 55 in June 2002 due to the merging of six institutions into three and the liquidation of another. However, the sector remained highly concentrated with 9 of the 43 banks controlling 74% of the total assets in the sector. A number of banks closed some branches as part of their cost and business rationalization measures. As a result, the branch network of commercial declined for 488 at the end of June 2003 from 497 in June 2002. Foreign exchange bureaus stood at 47 in June 2003 from 48 at the end of June 2002 following the closure of one up-country foreign exchange bureau. In order to enhance competition in the foreign exchange market, the moratium imposed in October 1999 on the licensing of new foreign exchange bureaus was lifted during the year to allow entry of more foreign exchange bureaus (CBK, 2003).

Following improved economic performance, the banking sector grew strongly in the financial year 2003/2004. Profitability, deposits and capital, all grew significantly and a higher rate of compliance with statutory and prudential regulations was achieved. Most commercial banks in Kenya have adopted performance contracting including Barclays Bank, Consolidated Bank, Cooperative Bank and National bank of Kenya

1.1.4 National Bank of Kenya

National Bank of Kenya Limited (NBK) was established in 1968 by an Act of parliament. It officially opened on Thursday November 14^{th} 1968 the main objective being to help Kenyans access credit and control their economy after independence. The first branch to be open was at development house, Nairobi in 1968 (NBK, 2010)**.**

Initial capital was put in by government in the tune of 5 million and thus fully owned the bank (memorandum & articles of association of NBK). In 1994 the government reduced its shareholding by 32% which was equivalent to 40 million shares by selling to the public. An additional 40 million were offloaded to the public in 1996.

The current shareholding stands at NSSF 48.06%, general public 29.44% and Kenya government 22.5%.Share capital was further increased by 6 billion through creation of 1.2 billion non cumulative preference shares of Kshs.5 each (NBK, 2011).The bank operates one subsidiary company: Natbank Trustee and Investments Services LTD incorporated on 21st July 1995 in Kenya with a share capital of Kshs. 10 million.

In 1998 there was a run on the bank by its customers following the tabling in parliament of a list of loan defaulters by the then finance minister Hon. Simeon Nyachae, M P, majority of who were powerful politicians (NBK Board Paper 1998). In the year 1999 NBK recorded a loss of Kshs.3.4 billion which was the highest ever loss recorded by any financial institution in Kenya.

The bank has a total of 52 branches and sub branches countrywide and an estimated customer base of about 1.5 Million customers, spread across its seven regional offices. These regions include Coast, Mount Kenya, Rift Valley, Nairobi North, Nairobi South, Western and Head Office. The bank positions itself as a financial and services provider to all income groups and offers diverse financial products, typically savings based products and accounts, in line with its mandate of encouraging thrift and inculcating a savings culture. Examples of products and services offered by the bank include RTGS and SWIFT, Foreign Currency accounts, Savings accounts, Salary processing, Premium Savings Accounts, Children A/c's, Kenya National Examination's Council, retail banking and corporate banking,(NBK,2011).

NBK's organizational structure is function based, as depicted below. The Managing Director reports to a Board of Directors (BOD).Functional Divisions, mainly headed by General Managers, report to the two Deputy Managing Director who report to the Managing Director. For instance, General Manager, Information and Communications Technology (ICT) and the G.M - Human Resources, both report directly to the Deputy Managing Director – Support Services. With the recent expansion the bank has a staff of approximately 1,500 personnel, in its entire fifty two branches, around the country as outlined above (NBK, 2011).

In line with other state owned agencies, National bank's performance contracting was sanctioned by the board of directors in 2008 (NBK board paper 2008) it is important to note that government through its shareholding still has a serious and major control over the functioning and operations of the bank. NBK operates as a quasi state agency with major government decisions being approved by government through the permanent secretary treasury.

1.2 Research Problem

A Performance Contract is an agreement between an owner and an agent which establishes general goals for the agency, sets targets for measuring performance and provides incentives for achieving these targets, (GoK, 2005a). In Kenya, performance contracting is a hybrid system that has borrowed from international best practices and the Balanced Score Card. The Performance Contracting and Evaluation system best practices were drawn from: South Korea, India, China, USA, United Kingdom, China, Malaysia and Morocco but domesticated to suit the local context. The Balanced Score Card as an evaluation tool provides a logical connection between the vision, mission and strategic objectives with the desired results in terms of customer and stakeholder needs, financial/budget, internal processes and capacity building (learning and growth). It also links strategic objectives to long term targets and annual budgets.

Performance contracts clearly spell out the desired end results expected of the contractor or officers who have signed the contracts. The manner in which the work is to be done is left up to the officer who is given as much freedom as possible in figuring out how best to meet the organization's performance objective.

Performance contracting has been introduced in many organizations both private and public across the globe. Most of the organizations that have implemented this method of management have seen an increase in accountability and thus increased efficiency. In private entities specific measurable results have been witnessed directly linked to performance contracting while in public sector service delivery to the public enhanced.
However, not all organizations that have embraced this concept report the same results. Some continue stagnating at the same spot while others have faced serious challenges including resistance by staff.

Shirley and Xu, (2000), highlight a number of factors that could hinder implementation of performance contracts. Such include fear of the repercussions of not achieving the signed targets, negotiations by the lower cascades and general fear of the unknown.
Studies have been carried out on performance contracting which has been introduced across many countries worldwide. In Kenya only a few studies have been done on the Kenyan perspective. Kobia, (2006), sought to find out the management perspective of performance contracting in state corporations. Obaga (2008) sought to specifically assess the implementation of performance contracting at Kenyatta National Hospital.

Kisilu (2012) sought to establish the management perspective of factors affecting implementation of performance contracting in commercial state corporations a case of Consolidated Bank. Akaranga (2012) critically reviews literature on performance contracting while Kobia (2006) sought to explore the Kenyan experience with performance contracting. UNDP (2009) equally commissioned a study on the effects of performance contracting in the public sector service delivery in Kenya.

National bank of Kenya introduced performance contracting in 2009 after the bank signed its contract with the ministry of finance. The purpose of this was to increase efficiency, profitability and value for shareholders who include government. This was also in line with other state agencies that were conforming to requirements by the government to adopt performance contracting. NBK board paper (2009)

To the best of the researcher's knowledge no study has ever been carried out on the implementation of performance contracting at National Bank of Kenya. The researcher seeks to study the challenges facing implementation of the same at the bank. Therefore, what are the challenges facing the implementation of performance contracting at the National Bank of Kenya?

1.3 Research Objective

The research objective was to determine the challenges facing the implementation of performance contracting at the National Bank of Kenya.

1.4 Value of the study

The study will be beneficial to management practitioners and academia that may use the findings as a source of reference in various forums. The study will further form basis for further study in the area of performance contracting and especially best practices in implementation to maximize on the benefits. The findings of this study will add to literature that continues to grow on performance contracting.

The government of Kenya shall also be a great beneficiary of findings of this study as a major shareholder at National Bank and for use of the findings in other state agencies, ministries and departments. The findings of this study at National Bank can be extrapolated to other state agencies that may be facing challenges in performance contracting.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Literature review is a body of text that aims to review the critical points of current knowledge including substantive findings as well as theoretical and methodological contributions to a particular topic. Literature reviews are secondary sources, and as such, do not report any new or original experimental work. The researcher reviews literature in on various aspects relating to performance contracting, the agency theory and previous studies undertaken on performance contracting in various public agencies in Kenya.

2.2 The concept of performance contracting

Performance contracting is a strategic management tool in which principals sign a performance agreement with their agents on various deliverables. Such deliverables may be profit, service standards, staff turn-over and many other business activities. The aim of performance contracting both in public and private sector is aimed at improving efficiency and effectiveness in the management of the organization's affairs. In the public sector governments use performance contracting in the wider reform process to improve public administration and service delivery to the people, (Larbi, 2001). In the private sector such contracts are used to measure exact performance of individual staff as well as the entire organizations.

Performance contracts are set out and signed at board levels and cascaded downwards to all employees of the organization who should the all work towards achievement of the wider goals of the entire organization. The contracts outline specific outcomes expected within certain timelines outlined in the contracts.

However while this concept seems to work in many organizations in others it has been seen to fail either at the introduction or implementation stage. Trivedi (1990a) pointed out that the problems inhibiting the performance of government agencies have been identified as: excessive controls, multiplicity of principals with multiple and sometimes conflicting objectives, frequent political interference, poor management and outright mismanagement.

A Performance Contract is a freely negotiated performance agreement between the principal, and the management of the Agency. It clearly specifies the intentions, obligations and responsibilities of the two contracting parties.

2.3 Rationale for Performance Contracting

The primary theme in performance contracting (PC) arrangements is to improve enterprise performance towards its goals such as cost competitiveness, design, quality control and marketing and to promote effectiveness and responsiveness (UN, 1995a, OECD, 1999). According to the UN, the PC system addresses three of the key problems facing public agencies *viz* ill-defined and un-reconciled goals, political and bureaucratic intervention on operational decision – making and management rewards which are often fixed irrespective of effort or results achieved. Besides these problems, the performances of public agencies are sometimes afflicted by poor management and outright mismanagement (GoK, 2005a).

Public agencies are often accused of lack of accountability to the public and also to their principals. According to Trivedi (2005), two main reasons for lack of accountability have been identified. The public enterprises normally have multiple principals who have multiple and often conflicting goals that the public agency must accommodate. For instance a typical public agency in Kenya, in fulfilling its mandate, will need to satisfy the following principals:- Parliament through legislation; the parent ministry; Ministry of Finance for financial purposes; Ministry of Planning and National Development and the Office of the President for supervision (GOK, 2005a).

Stakeholders of the public agency also have a range of objectives that are often conflicting. Some are interested in political desires, others in efficiency, some in profitability, other in maximizing productivity, while others want equity, (Trivedi, 2005). The multiplicity of principals and conflicting objectives leads to unclear transmission of objectives to managers of public agency. These fuzzy objectives in addition to having multiple principles result in a "denial" syndrome in the event that things are not working well as expected and no one wants to take responsibility for the failure

Trivedi (2005) argues that a performance contract is the management tool that best resolves this impasse. The manager of the public agency will list the objectives of the agency, identify and select performance criteria against which the agency and the manager will be evaluated. In the process, performance contracts improve public agency accountability. They also break the denial syndrome as they, PCs, force the contracting parties to identify who is to do what and when.

The traditional method of evaluation of commercial enterprises has been profitability. As the Commonwealth Secretariat, (1995), argued, public enterprises could be recording losses on the basis of current operations, but such balance sheet results alone are not sufficient to indicate the level of effort put in and the success achieved by the management of public enterprise in improving on their previous year's operations. If a PC signed by the management of such public enterprise sets a target for the year to reduce loss from the previous year's level, the achievement of such a target should win commendation, boost the morale of the current management and spur them on to better performance.

When the focus for the government and public enterprises is on results, Public Enterprise (PE) managers would wish to claim autonomy, (Trivedi, 2005). This claim would be justified in the context of operational autonomy rather that strategic autonomy. It is important to distinguish here that strategic autonomy refers to freedom to decide the direction and goals of the PE. The former is the prerogative of the owners of the PE and the latter is legitimate requirement for effective management. Performance contracts give leeway to the PE managers to exercise such operational autonomy.

2.4 Types of Performance Contracts

Public management scholars, practitioners and consultants are in agreement that there are mainly two types of performance contracts namely the French-based system and the signaling system. All other arrangements fall under one or the other (Trivedi, 1990; Commonwealth Secretariat, 1995). As the name suggests, the French-based system is that which originated from France and concretized by the Nora Report while signaling systems originated in Pakistan and Korea.

While the two contract systems both address the issue of promoting performance, by specifying the goals to be achieved and the obligations of the government and the agency, they exhibit different approaches. The French contract system does not clearly specify what targets are to be achieved but the signaling system does specify for ease of evaluation of performance. For instance, the SNCF stated that one of its aims was to transform it from a highly centralized organization to more centralized command structure better meeting the requirements of a modern enterprise. Similarly, ORTF was asked to attempt a more active and specific participation in educational, cultural and research activities related to broadcasting, and urged to apply that is in the public interest (Trivedi, 1990a). It is not easy to evaluate the achievement of these goals objectively, and public interest could draw several perceptions from different individuals.

A performance contract has alternative names depending on the country of reference. The other names include Performance Agreement, Contratos de Rendimientos, Contrat du Plan, Contrat de Program, Framework Agreement, Memorandum of Understanding, Letter of Responsibility, or Public Service Agreement (Trivedi, 1990a; UN, 1995a; OECD, 1999).

2.5 Performance Management

The term' performance management' is often used by different people to discuss varied issues. In the context of this article performance management refers to the management of the services or processes which enable both individuals and organizations to focus effectively on the creation and sustained development of a high performance culture in the organization, (Blanchard, Hersey, & Johnson, 1996; Armstrong & Murlis, 2004 ;NPR, 1999). According to Armstrong and Murlis (2004), it is a process of establishing a shared understanding about what is to be achieved and the systems necessary to attain the achievement. Blanchard et al (1996), simplify this as referring to situational leadership and the achievement of organizational productivity through effective management.

In focusing attention to performance management the Performance Based Management Special Interest Group (PBM SIG) identified four guidelines, namely: establishing strategic performance objectives; measuring performance; collecting, analyzing, reviewing and reporting performance data; and using that data to drive performance. This is by no means a prescription for performance management practice, (PBM SIG, 2001). When compared to the stages in strategy development and implementation, the PBM SIG model does appear to assume the implementation stage upon which measure of performance would be based.

Performance management underscores the interrelationship between formulation and success in strategy implementation. When properly implemented, the performance management process will lead to continuous improvement. Performance contracting has emerged as a robust concept to strengthen the performance management process.

2.6 Prerequisites Necessary for Effective Performance Contracting

Various countries of the world face different circumstances in the delivery of public services and are bound to have different requirements for introducing performance contracts. The prerequisites mentioned below are thus the more generic ones that apply in the majority of performance contracting situations.

UN (1995a) identified four factors that need to be satisfied if performance contracting is to succeed, namely: financial stability of an agency; management information and regulatory capacity; stable and competent management team; and a firm government commitment. Many public agencies find themselves crippled by debt and illiquidity due to accumulated losses, or under capitalization in some cases. Few such firms are likely to meet performance targets. The UN cites examples of two Kenyan Public Enterprises (PEs), the National Cereals and Produce Board and the Kenya Railways Corporations that were heavily indebted to the government when variants of performance contracts were introduced in this PEs in 1990 but they failed to improve performance when the said PEs could not service their debts.

Trivedi (1990a) and GOK (2005b) advance the view that a standard performance contract consists of three subsystems, namely; performance information system; performance evaluation system; and performance incentive/sanctions system. Information system relates to the need to have a reasonable balance of information between the government and its agencies in the process of negotiating performance contracts. In the event of information asymmetry, performance contracts become ineffective (Jones, 1991; Shirley, 1998; Shirley and Xu, 2000).

Information enables an evaluator design an effective evaluation system. The first step is to decide on a set of appropriate criteria for evaluating agency performance (Trivedi, 1990a). Trivedi proposes that deciding on criteria approaches performance measurement on four fronts.

He identifies the fronts as static efficiency, dynamic efficiency, project implementation and achievement of non-commercial objectives. Static efficiency enables a firm to determine how efficient its resources are being utilized. Dynamic efficiency criteria include activities that have costs (benefits) in the present but generate benefits (costs) in the future such as research and development. Project implementation enables a firm identify how efficiently projects are implemented while it must also identify systems to measure achievement of non-commercial activities.

Performance incentive/sanctions system relates to a system that links rewards/sanctions with measurable performance. An evaluation process that does not link the evaluation of performance to the welfare of manager may not improve performance. An evaluation system provides the necessary platform to design an appropriate incentive system and adequate information system.

Trivedi (1990a) notes that performance contracts are expected to clarify agency objectives and reconcile priorities ex-ante so that managers of public agencies could be held unambiguously accountable ex-post for achieving those objectives. Determination of ex-ante relationship means that the targets are set prior to commencement of the performance contract so that managers can be fairly held accountable for their achievement or lack of it at the end of the performance contract period.

Public management scholars, consultants and practitioners are in consensus about the fundamental preconditions necessary to ensure success of contracts on the basis of ex-ante justification. According to Trivedi (1990b) the preconditions can be categorized into two categories – those dealing with criteria and those dealing with institutions. Trivedi identifies three preconditions relating to criteria selection, *viz:* performance criteria included in the contract must be clearly defined and easily understood; criterion should be fair to the manager, that is, to encompass only areas within the control of the public agency; and the criteria for evaluating public agency performance must be fair to the country.

Public agency managers should not be rewarded for actions which appear to improve the performance of the agency at the cost of the nation's overall welfare such as increased pollution or environmental degradation.

Institutional preconditions for carrying out contracts implementation were also identified to include: Performance targets to be negotiated at the beginning of the period, not imposed arbitrarily from the top government; public agency managers must be left free to manage the agency within the agreed parameters; at the end of the period, the performance of the public agency is to be judged systematically against the targets negotiated at the beginning of the year; to carry out performance evaluation it is necessary to have a balance in the availability of information between the evaluator and the evaluatee; and the evaluation of the public agency should be done by a competent authority whose recommendations shall be credible. The performance result should then be linked to a system of incentives or sanctions for good or poor performance respectively.

Public management literature embodies a number of other preconditions which include leadership in championing the cause; existence of a strategic plan with clear organization objectives; a conceptual framework to enable the agency to focus its measures; commitment by everyone since the degree of commitment will determine the degree of success; involvement of all stakeholders, customers and employees; and creation of a sense of urgency to move to a new and enhanced performance measurement and management regime (Trivedi, 1990a; OECD, 1999; PBM SIG, 2001).

2.7 Agency Theory

Agency theory suggests that the firm can be viewed as a nexus of contracts (loosely defined) between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents (Kleiman, 1999). The primary agency relationships in business are those (1) between stockholders and managers and (2) between debt holders and stockholders (3) Governments and ministries, departments and agencies (Klaus Spremann et.al 1987).

These relationships are not necessarily harmonious; indeed, agency theory is concerned with so-called agency conflicts, or conflicts of interest between agents and principals. This has implications for, among other things, corporate governance and business ethics. When an agency relationship occurs it also tends to give rise to agency costs, which are expenses incurred in order to sustain an effective agency relationship (e.g., offering management performance bonuses to encourage managers to act in the shareholders' interests). Accordingly, agency theory has emerged as a dominant model in the financial economics literature, and is widely discussed in business ethics texts, (Bamberg & Klaus, 1987).

Agency theory in a formal sense originated in the early 1970s, but the concepts behind it have a long and varied history. Among the influences are property-rights theories, organization economics, contract law, and political philosophy, including the works of Locke and Hobbes. Some noteworthy scholars involved in agency theory's formative period in the 1970s included Armen Alchian, Harold Demsetz, Michael Jensen, William Meckling, and S.A. Ross.

2.8 Previous and related studies

Dr Margaret Kobia (2006) studied the Kenyan experience with performance contracting. In her article titled the Kenyan experience with performance contracting she outlines the history of performance contracting in Kenya stating that although there have been several initiatives since 1993, performance contract was implemented in Kenya in 2003. According to Kobia this was the Government’s attempt to provide a unifying framework within which performance can be managed in the public service to achieve the goals outlined in the Economic Recovery Strategy. Kobia studied the rationale, objectives and impacts of performance contracting in various ministries departments and agencies. Obaga (2008) sought to study the implementation of performance contracting at Kenyatta National hospital. In his findings Obaga concludes that performance contracting at the hospital enabled it enhance service delivery and reduce wastage of resources

Kiboi (2006) sought to find out the management perspective of performance contracting in state corporations. His research concludes that while managers' sign the contracts they did so just to satisfy the requirement of the public service commission. Most managers feared that such contracts were to be used to intimidate, transfer or sometimes sack them.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the research design, population under study, the sampling design, data collection tools and how data shall be analyzed.

3.2 Research Design

This research was a case study. Case study designs are appropriate when in-depth information is desired for describing phenomena of interest in a single unit of study (Bryman, 1989, Kothari, 1990). Descriptive research was used to conduct this study. According to Cooper and Schindler (2003) descriptive research is concerned with finding out who, what, where when and how of a relevant phenomena and will definitely therefore be relevant for this study since the researcher intends to describe the challenges experienced in implementing performance contracting at the bank. Other researchers have successfully used this design including Ciano (2006), Korir (2006) and Obaga (2008).

3.5 Data Collection

The researcher collected both primary and secondary data for this study. Primary data was collected through personal interviews of selected senior managers and middle level managers. This enabled the researcher collect the various views from general managers who were in charge of negotiating the contracts and the senior managers who implement the contracts at lower levels. The researcher identified target respondents clearly targeting representation from departments that have significant roles in the implementation of performance contracting at the bank.

The respondents included the Executive Director Human Resources, General Managers in the departments of Finance, Marketing, Operations and ICT and Branch Managers of Harambee Avenue, Kenyatta Avenue, Nkrumah road, Kisumu, Meru, Eldoret and Kakamega.

3.6 Data Analysis

Analysis of data is a process of inspecting, cleaning, transforming, and modeling data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making Mugenda and Mugenda (2003). Data analysis that is well done gives proper meaning to the entire process of research

It is with this in mind that the researcher carefully cleaned, sorted and coded the data before content analysis was done. The analyzed data is then be interpreted and conclusions drawn with a view of relating the content or theoretical arguments to the context of study.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The researcher interviewed departmental general managers and middle level managers on three thematic areas. These were on their knowledge and understanding of performance contracting, involvement of staff in the development and implementation of strategic plans and performance contracts and the challenges experienced in the implementation of performance contracts. This chapter presents discussions on the responses obtained in two sub sections. The first section covers the departmental general managers while the second section covers the middle level managers.

4.2 Departmental General Managers

4.2.1 Knowledge and Understanding of Performance Contracts

This study sought to find out the knowledge and understanding of the departmental general managers by establishing their work experience at National Bank, their views on the introduction of performance contracting and if performance contracts are accorded importance at their level within the organization.

The findings indicated that the general managers had served for an average of 14 years at the bank with the lowest having five years and the highest has been at the bank for 25 years. All the managers were affirmative that the organization puts emphasis on performance contracts at their level. This was expressed by their understanding that their input was important for the attainment of the general objectives of the bank. The main objective of introducing the performance contracts in the opinion of the general managers was to improve efficiency and grow the bank’s business. This is mainly through the prioritization of key corporate goals and creating focus on key performance indicators so as to enhance productivity and by extension the bank’s profitability. They indicated that performance contracts also facilitate the measuring of performance of individual employees and functional units within the bank.

4.2.2 Employee Involvement

This study sought to find out the employee involvement in the implementation of performance contracts by establishing their preparation, employee involvement in setting performance goals and operationalization of performance contracts.

The respondents indicated that effort was made to prepare the employees to work with the new concept of performance contracts. This was done through the provision of in-house training, and guidance on the implementation process. However, it emerged that these efforts were not enough as some of the respondents indicated that there was need for a longer sensitization period. Other respondents expressed this by indicating that there was need for more education on the implementation process.

The study established that the employees at National Bank were involved in setting performance targets at all levels. The process is designed to be inclusive by incorporating the participation of employees at the strategic, functional and individual employee levels. At the strategic level, goals are set following agreements between the board and the chief executive officer. These are then cascaded to the functional departments and further to the individual employees depending on their specific roles within the bank. The bank also seeks the input of employees in the development of the strategic plan and the setting of goals. The budgetary process involves contributions from employees at the departmental level which is then forwarded to the board for guidance and approval.

The respondents indicated that the bank operationalizes the employee performance contracts through its organizational structure. In its simplest form it involves an employee agreeing with their supervisor on targets and the timelines within which these are to be delivered. This way, the organization is able to establish a link between individual performance plans for agreed targets and its overall strategy. Semi annual reviews are then conducted as follow ups on the performance contract for each employee.

4.2.3 Challenges in the Implementation of Performance Contracts

This study sought to identify the challenges faced in the implementation of performance contracts at National Bank. To achieve this, the study considered availability of resources, a monitoring system and the specific challenges. It also sought to find out if these challenges are being addressed as well as giving the respondents an opportunity to suggest ways of addressing these challenges.

While some of the departmental managers indicated that they had sufficient resources necessary for them to carry out the tasks outlined in their performance contracts, it emerged that there was need for capacity building both in terms of human resource and physical infrastructure. The respondents indicated that since the organization is still in transition, the evolution of a performance based system needed more personnel who were better equipped and trained in ICT skills.

The study found out that there is a monitoring and evaluation mechanism put in place to provide feedback on employee performance. This was done through semi-annual reviews on targets which have been deliberately designed to have measurable indicators. The review mechanism involves the employee, an appraising supervisor, a HR reviewer and finally a HR committee. It is important to note that while the bank has made effort to make this process impartial, there are respondents who were of the opinion that it lacked independence since it involved internal employees of the bank.

Apart from the perception of a lack of independence of the monitoring and evaluation mechanism, the respondents also raised a number of challenges that have arisen with the implementation of the performance contracts. They noted that there exists a component of resistance to change by a number of the employees. Performance contracting being a new idea, there are cases of employees who demonstrate resistance to the new requirements and prefer to conduct business in the old ways. Closely related to this is the difficulty being experienced by employees who are unable to differentiate between routine tasks and true key performance indicators. Some of the respondent also expressed that inadequate resources was presenting a constraint on their ability to meet their performance obligations. This is mainly attributed to under-budgeting for the various departmental needs. Some managers also indicated that it was not easy to provide a standardized comparison of output amongst employees who perform different tasks which complicates efforts to link performance to the reward system.

To address these challenges, the respondents suggested that there was need for more training and sensitization for the employees on the concept of performance contracting. The respondents emphasized that the training should focus more on better communication skills and establishment of better feedback mechanisms. The respondents further suggested that there is need to establish a clearer link between the reward system and output. It also emerged that the bank had recorded slow progress in attaining success with performance contracting. The slow uptake was noted as a challenge by the respondents who suggested that the bank should put in place a systematic implementation mechanism with closer and stricter monitoring to address the challenges as they arise.

4.3 Middle Level Managers

Similarly, the responses obtained from the middle level managers are discussed under the three thematic areas of knowledge and understanding of performance contracts, employee involvement and challenges in the implementation of performance contracts

4.3.1 Knowledge and Understanding of Performance Contracts

This study sought to establish the level of understanding and knowledge of middle level managers on the concept of performance contracting. This involved asking questions on their familiarity with performance contracting and the strategic plan as well as the relationship between the two at National Bank of Kenya.

Most of the respondents demonstrated some level of awareness about the performance contracting process and the strategic plan at National Bank of Kenya. They indicated that all managers signed their performance contracts at the beginning of the year based on the strategic plan. They reported that this was documented in written documents. These are then shared by all employees in department thus helping in defining and communicating the departmental targets and the overall strategic objectives for the organization. The respondents noted that it is a challenge to follow up on these targets since some units such as branches have clear targets while others such as headquarters do not.

4.3.2 Employee Involvement

This study sought to establish the involvement of employees in the implementation of performance contracts. This was established by probing the respondents on their preparation to work with the PCs and their involvement in the implementation of the PCs at National Bank.

The middle level managers involved in this study indicated that there was an effort to prepare all employees to work with the new performance contracts before they were introduced. This was done through training workshops, seminars which were facilitated by experts including external facilitators. These forums prepared the respondents both mentally and physically for the implementation of the performance contracts. They appreciated that despite these efforts; they did not fully understand the new concept and therefore requested that there should be more training and awareness initiatives to sensitize employees.

The respondents indicated that given their positions within the bank, they were actively involved in the implementation of performance contracts within their departments. They also indicated that there were efforts to actively involve all other employees in the implementation process. This is done through involving them in the development of budgets, seeking feedback from their juniors on challenges emerging on the implementation of performance contracts, as well as in setting departmental targets in line with the bank's strategic goals.

4.3.3 Challenges in the Implementation of Performance Contracts

This study sought to find out the challenges that the middle level managers experience in the implementation of performance contracts in the bank. This was done by probing the respondents on specific challenges as well as giving them a chance to suggest ways through which these could be addressed.

Change management and resistance to change emerged as the major challenges faced by the middle level managers. It emerged that this affected the managers and the junior staff in their departments. Some of the respondents reported that it is hard for most of them to transition from the old ways to the new approach under performance contracting. Providing clear definition of the key performance areas as well as lack of leadership and collective team responsibility on delivering on agreed on targets also emerged as key challenges to the implementation process.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the findings discussed in the previous chapters, conclusions on the challenges facing the implementation of performance contracts at National Bank of Kenya and the recommendations of the study

5.2 Summary

5.2.1 Knowledge and Understanding of Performance Contracts

This study established that there has been an effort to sensitize employees of National Bank on the performance contracts. This was done through trainings facilitated by experts on the topic. The employees were trained on the significance of performance contracts on the attainment of organizational goals. Through such trainings, the employees were equipped with the skills necessary for them to prioritize key corporate objective areas and performance indicators.

The employees were also aware of the expectations on them from their performance contracts. This study found out that managers signed performance contracts at the beginning of each year in which their targets were stipulated in line with the strategic plan of the bank. This were then documented in writing and shared within the department.

5.2.2 Employee Involvement

This study established that the National Bank of Kenya made an effort to involve their employees in the implementation of the performance contracts both before they were introduced and even in the actual implementation process. These efforts took various formats. Trainings were conducted to prepare the employees to work with the new concept of performance contracting. The bank also encouraged employee participation at all levels of developing and implementing performance contracting cycle through discussions on targets and methods of attaining them.

5.2.3 Challenges in the Implementation of Performance Contracts

From the responses discussed in the previous chapter, several challenges emerged. These challenges pointed towards the existence of various issues ranging from organizational weaknesses to issues to do with individual attitudes towards change. The challenges include resistance to change, inadequate resources, lack of complete understanding of the performance contracting concept and lack of strong leadership necessary to achieve the strategic goals of the bank.

5.3 Conclusion

This study concludes that the following are the challenges identified as facing the implementation of the performance contracts at National Bank of Kenya.

Lack of universally defined targets for all units within the bank - While some units such as the Branches do have clearly defined targets, others such as the Head Office do not.

Resistance to change amongst the employees - Performance contracting being a new concept, there are those employees who find it easier to conduct business under the old order.

The definition of key performance indicators is unclear thus some employees are unable to differentiate between routine tasks and these key performance indicators.

There is an indistinct link between the reward system and performance.

There is a lack of collective responsibility in the delivery of set targets. This is further aggravated by lack of a strong leadership necessary for the implementation of a new concept such as performance contracts.

A relatively short sensitization period resulted in the employees having an imperfect understanding of the concept.

Inadequate resources both in terms of physical infrastructure and personnel compromise the ability of managers to deliver on their performance contracts.

5.4 Recommendations

Based on the challenges identified in section 5.3, this study recommends the following

The bank should develop clearly defined targets for all it functional units.

More efforts should be made to address factors that may contribute to resistance to change among employees.

The key performance indicators under the performance contracts should be clearly defined to distinguish them from routine tasks.

There should be continuous sensitization of the employees to increase their understanding of the concept.

The bank should conduct a resource audit to determine the optimal level of resources; both infrastructure and personnel, required for the attainment of its strategic objectives

5.5 Areas for further study

The researcher recommends that a replicate study be done on other organizations so as to find out how other organizations successfully implemented Performance Contracting and how they dealt with similar challenges since each organization employs a different approach. The researcher further recommends that a similar study be done on other organizations for the purpose of benchmarking.

REFERENCES

Ansoff, H. I. (1965), *Corporate strategy: An analytic approach to business policy for growth and expansion.* New York: McGraw-Hill.

Arieu, A. (2007), *The Art of Strategic Managemnt to Reach Success.* Business & Finance.

Armstrong, M., & Murlis, H. (2004). *Reward Management: A Handbook of Remuneration Strategy and Practices* (5th ed.). London: Hay Group.

Bamberg, G., & Klaus, S. (Eds.). (1987), *Agency Theory, Information and Incentives*. Berlin: Springer-Verlag.

Blanchard, K., Hersey, P., & Johnson, D. (1996), *Management of Organizational Behaviour: Utilizing Human Resources* (7th ed.). Upper Saddle River, NJ: Prentice-Hall.

Bryman, A. (Ed.). (1989), *Research Methods and Organizational Studies.* London: Routledge.

CBK. (2012), *Commercial Banks and Mortgage Finance Institutions*. Retrieved October 22, 2012, from Central Bank of Kenya: http://www.centralbank.go.ke/index.php/bank- supervision/commercial-banks-mortgage-finance-institutions

Commonwealth Secretariat. (1995), *Performance Contracts: A Handbook for Managers.* London.

Cooper, D. R., & Schindler, P. S. (2003), *Business Research Methods* (8th ed.). Boston: Tata McGraw-Hill.

GoK. (2005b), *Information Booklet on Performance Contracts in the Public Service.* Nairobi: Unpublished Information Booklet, Government of Kenya.

GoK. (2005a), *Sensistization/Training Manual on Performance Contracts Steering Commitee.* Nairobi: Government Printer.

Hambrick, D. (1981), Specialization of Environmental Scanning Activities among Upper level Executives. *Journal of Management Studies,* 18 (3), 299-320.

Jones, L. (1991), Performance Evaluation for State Owned Enterprises. In R. Ramamurti, & R. Vernon (Eds.), *Privatisation andControl of State Owned Enterprises.* Washington D.C: The World Bank.

Kiboi, A. (2006), *Management Perception of Performance Contracting in State Corporations.* Nairobi: Unpublished MBA Research Project, University of Nairobi.

Kleiman, L. (1999), Human resource development. In M. Helms (Ed.), *Encyclopedia of Mangement* (4th ed., pp. 375-379). Detroit: Gale Group.

Kobia, M. (2006), *The Kenyan Experience with Performance Contracting*. AAPAM.

Korir, P. (2006), *The Impact of Performance Contracting in State Corporations: The Case of East African Portland Cement Company Limited*. Nairobi: Unpublished MBA Research Project, University of Nairobi.

Kothari, C. R. (1990), *Research Methodology: Methods and Techniques* (2nd ed.). New Delhi: New Age International (P) Limited.

Larbi, G. A. (2001), Performance contracting in practice: Experience and Lessons from water sector in Ghana. *Public Management Review,* 3 (3), 305-324.

Mugenda, O., & Mugenda, A. G. (2003), *Research Methods: Quantitative and Qualitative Approaches* (1st ed.). Nairobi: ACTS Press.

NBK. (2007), *NBK Board Papers*. Nairobi: National Bank of Kenya.

NBK. (2008), *NBK Board Papers*. Nairobi: National Bank of Kenya.

NBK. (2009), *NBK Board Papers*. Nairobi: National Bank of Kenya.

NBK. (2011), *NBK Board Papers*. Nairobi: National Bank of Kenya.

NPR. (1999), *Balancing Measures, Best Practices in Performance Management.* New Partnership for Reinventing Government, Department of Energy, USA.

NSE. (2012), *Listed Companies*. Retrieved October 22, 2012, from Nairobi Securities Exchange: http://www.nse.co.ke/listed-companies/list.html

OECD. (1995), *Governance in Transition: Public Management Reform in OECD Countries.* Paris: Organisation for Economic Co-operation and Development.

OECD. (1999), *Performance Contracting: Lessons from Performance Contracting Case Studies –A framework for Public Sector Performance Contracting.* Paris: Public Management Service/ Public Management Committee(PUMA/PAC 99), Organisation for Economic Co-operation and Development.

PBM SIG. (2001), *The Performance Based Management Handbook: Establishing and Maintenance of a Performance Based Management Programme* (Vol. 1). Oak Ridge institute for Science and Education.

Shirley, M. (1998), *Why Performance Contracts for State Owned Enterprises Haven't Worked.* Washington DC: World Bank Development Research Group.

Shirley, M., & Xu, C. L. (2000), Emperical Effects of Performance Contracts: Evidence from China. *Journal of Law Economics and Organisation* , 17 (1), 168-200.

Trivedi, P. (2005), Designing and Implementing Mechanisms to Enhance Accountability for State Owned Enterprises. *Expert Group Meeting on Reinventing Public Enteprises and its Management.* New York : United Nations Building.

Trivedi, P. (1990b), Performance Evaluation System for Memoranda of Understanding. In P. Trivedi (Ed.), *Memorandum of Understanding : An approach to Improving Public Enterprise Performance* (1st ed.). New Delhi: International Management Publishers.

Trivedi, P. (1990a), Theory and Practice of the Contracting Approach: Lessons for LCDs. In P. Trivedi (Ed.), *Memorandum of Understanding : An Approach to Improving Public Enterprise Performance* (1st ed.). New Delhi: International Management Publishers.

UN. (1995b), *Guidelines for Performance Contracting*. New York: The United Nations.

UN. (1995a), Paper presented at the Expert Group Meeting on 26-27 April 1994. *Performance Contracting for Public Enterprises*. New York: The United Nations.

Appendix 1: INTRODUCTION LETTER

Dear respondent,

My name is a Sylvia Cherotich Koech, final year MBA student at The University of Nairobi. As part of my course work I am required to conduct a research in my area of study. I request that you kindly take a few minutes to help me answer this interview questions.

The topic I have chosen to study is; **CHALLENGES FACING THE IMPLEMENTATION OF PERFORMANCE CONTRACTING AS A STRATEGY AT NATIONAL BANK OF KENYA**

My research so far has revealed that not much has been done in this field in Kenya, and with your help, I would like to change that.

Kindly take a few minutes of your time to answer questions in the attached interview. The research is purely for academic purposes and all information provided will be treated with utmost confidentiality. Therefore feel free to be as honest and accurate as possible.

Thank you in advance for your participation. If you have any questions or concerns regarding this study, please feel free to contact me.

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAMME

Telephone: 020-2059162
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE 08/09/2012

TO WHOM IT MAY CONCERN

The bearer of this letter SYLVIA CHEROTICH KOECH

Registration No. D61/8865/2006

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
26 OCT 2012
MBA OFFICE
P.O. Box 30197 - 00100, NAIROBI

IMMACULATE OMANO
MBA ADMINISTRATOR
MBA OFFICE, AMBANK HOUSE

Appendix 2: INTERVIEW GUIDE

SECTION: A

INTERVIEW GUIDE: GENERAL MANAGERS

1. How long have you worked for NBK in your current capacity?
2. What in your view is the goal of introducing performance contracting in the bank?
3. Were you prepared sufficiently to work with performance contracts before they were introduced?
4. To what extent are employees under you involved in setting performance targets for your function?
5. How do you operationalize your performance contract?
6. Do you have sufficient resources to enable you achieve the tasks in your performance contract?
7. Does NBK attach much importance to the performance contract at your level?
8. Is there an independent monitoring and evaluation system to give you feedback on your performance?
9. What are the specific challenges you faced during introduction of performance contracting at the bank in general
10. How can these challenges be addressed?
11. Would you say NBK has been successful or not in implementing performance contracting?
12. If the implementation was done differently would it have given different results?

SECTION: B

INTERVIEW GUIDE: FOR MIDDLE LEVEL MANAGERS/SUPERVISORS

1. Are you familiar with performance contracting at NBK?
2. Is the PC clearly communicated in NBK?
3. Are you involved in any way in the implementation of performance contracts in your department? What is your role?
4. Were you prepared sufficiently to work with performance contracts before they were introduced?
5. Are you aware of a strategic plan at NBK?
6. Do you know the link between the performance contract and the strategic plan?
7. What other challenges arise from the introduction and implementation of the performance contracting concept?
8. Is there any other information you wish to share about your experience with performance contracting at NBK?
9. If the implementation was done differently would it have given different results? Elaborate.