RELATIONSHIP BETWEEN CORPORATE GOVERNANCE STRUCTURES AND PERFORMANCE OF INSURANCE COMPANIES IN KENYA

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DECLARATION

This project is my original work and has not been presented for a degree in any other University

Signed---------- Date 5.11.2007

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This project has been submitted for examination with my approval as a university supervisor

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DEDICATION

To my wife Jane, Children Carol and Susan whose support and sacrifice has enabled me get this far

To my dear Mother Monica and Dad Allan for their prayers and moral support which has been a source of encouragement and blessings.

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ABSTRACT

This paper investigates whether corporate governance affects performance of Insurance companies in Kenya. Data on corporate governance characteristics and performance are constructed and regression analysis performed. The study includes five specific corporate governance characteristics. Thirty-three insurance companies were examined to establish the relationship between corporate governance and performance.

This research find evidence that the size of the board and insider holding on one hand have an association with performance but does not find any evidence that the external board, individual shareholding and institutional shareholding have any influence on performance. It thus supports the commonly held view in the literature that the small size of the board has a positive effect on performance. The negative relationship found in this research between performance and the number of external directors may be a peculiar one in Kenya for it is not consistent with the many past research findings. However, specific corporate governance features found in the insurance industry in Kenya play an important role in determining performance. The conclusion is that the size of the board and insider holding on one hand have an association with performance but does not find any evidence that external board, individual holding and institutional holding have any influence on performance of insurance companies.

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

Corporate Governance is currently a topical issue all over the world. With the opening up of the economies and liberalization, the concern for corporate governance has spread to the developing world where Kenya is a part. Corporate governance nurtures all progressive traits and at the same time discourages irregularities in corporates (Cadbury, [1992]). The insurance industry in Kenya is rather highly regulated although governance issues in the industry have been the focal point.

There are specific conflicts of interest that may arise in the insurance sector between managers and shareholders as well as between policyholders and managers, due to the fiduciary role of insurance companies. About two to three years ago, the Insurance Sector was faced with a serious financial problems due to declining economic growth in the country in the late 1990s, and an arrant of setbacks in the industry including; corruption, mismanagement, increasing claims, fraud, coupled with price under-cutting and other insurance liabilities. The failure of once a giant, The Kenya National Assurance Company was blamed on poor corporate governance and specifically mismanagement (Kenya

Insurance Survey, 2004). Corporate governance therefore is an important concept in the fight against wrong corporate behavior that often lead to the collapse of many business enterprises, Stiles (1993), and Demb and Neubauer (1992].

Insurance is a support to business activities through policy coverage of various risks, financial credit, investments and advice. Insurance Sector is dependent on the performance of other sectors in the economy like Agriculture, Transport, Health, Aviation, Building and Construction, etc. It also contributes in the stability of the economy through invisible earnings and provision of consumer benefits directly by way of insurance products on life, health, education, and agriculture, shipping among other things. It is therefore worth researching in the industry.

While existing study examined corporate governance on firm performance in Kenya, there is no study yet which analyses the effect of corporate governance mechanisms on insurance companies performance. This study tries to fill that gap. An empirical analysis of the effect of the corporate governance mechanisms which include number of directors, the percentage of external directors in boards, the percentage of individual &family shareholding, the percentage of insider shareholding and the percentage of institutional shareholders on performance is used.

In the insurance industry and Kenya in general, there will be those who say that corporate governance issues are not as critical so long as the business continues to perform well. Good performance always comes when corporate governance issues are affected. The relative lack of research, which proposes and documents a link between corporate governance structures and performance in such an important industry as Insurance, therefore, motivated this study.

1.2 RESEARCH PROBLEM

Insurance companies in Kenya are said to owe policyholders billions of shillings.

There have been cases of outstanding claims taking up to 5 years to settle thus leading to complaints by the policyholders. This is explained by the wide disparity between the liquid assets and outstanding claims in some Insurance companies that makes the underwriting business vulnerable to fraudulent claims and unprofitable business (Kenya Insurance Survey, 2004). It was therefore worthwhile to establish the impact of corporate governance on performance.

The failure of once a giant, The Kenya National Assurance Company was blamed on poor corporate governance and specifically mismanagement

(Kenya Insurance Survey, 2004). Corporate governance therefore is an important concept in the fight against wrong corporate behavior that often lead to the collapse of many business enterprises, Stiles (1993), and Demb and Neubauer (1992). This called for confirming whether this justifies the blame.

A number of researches have been done on corporate governance in Kenya. Much has focused on general corporate governance issues, (e.g., Jebet (2001), used financial ratios to evaluate quoted firms efficiency in assets utilization and their operating efficiency. The relative lack of research, which proposes and documents a link between corporate governance structures and performance in such an important industry as Insurance therefore, motivated this study.

It is some time now since Mwangi A.K, (2002) surveyed the Insurance industry having heavily relied on the Insurance report of 1999 which have now been overtaken by events taking into consideration the Kenya's political, social and economical changes and probable corporate governance issues that have come along with these changes. His study focused on ratio analyses of the Insurance companies using performance data mainly from the companies' financial reports.

The existing research also fails to control for non governance variables and endogeneity while linking governance variables to performance hence making them inconclusive and fragmented. Kenya is one of such countries where corporate governance systems are in the evolutionary stage, and therefore in addition to the findings of the existing research studies, this new findings will also be useful for the Insurance Industry.

The above issues therefore formed the basis of this study to establish the relationship between corporate governance with performance in the insurance industry in Kenya.

1.3 OBJECTIVE OF THE STUDY

- To inquire into corporate governance structures of Insurance companies in Kenya.
- To examine the relationship between corporate governance structures and the performance of insurance companies in Kenya.

1.4 IMPORTANCE OF THE STUDY

Shareholders and Investors

The study will help shareholders and investors know the various mechanisms through which they can exercise their control.

Stakeholders

It will enable the stakeholders understand the various roles and effects of board size and ownership structure in bringing about good corporate governance.

Researchers and academicians

Finally but not the least, it will add further insight to the existing study in the area of corporate governance as well as create challenges for further study.

CHAPETER 2: LITERATURE REVIEW

2.1 CORPORATE GOVERNANCE

In the fast changing world of business, good corporate governance can spell the difference between survival and continuing decline. With accountability, managers and controlling shareholders view their stewardship of the firm not as entitlement but rather as a privilege that must be constantly earned through excellent performance and results. Numerous recent studies emanating from academic circles show that good governance add value for the stakeholders. A recent study by Gompers, Ishii, and Metrick (2003) indicate that companies with strong shareholders rights yielded higher annual returns than those with weak rights do.

There will be those who say that fairness, transparency, and accountability are not as critical so long as the business continues to perform well. Countries around the world are characterized by alternative corporate governance systems (Shleifer and Vishny, 1997). In the last one decade or so, corporate governance codes have focused on compliance with procedures and having certain structures in place. The emerging focus now is on how boards perform in relation to specified principles, rather than how they claim to comply.

Theoretical models by La Porta, Lopez-de-silanes, shleifer and Vishney (2002) and Shleifer and Wolfenzon (2002) predict that investors pay more because they recognise that, with better legal protection, more of the firm's profit would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm.

Scholars have for almost seventy years studied on the topic of the link between ownership concentration and corporate performance and found that a more concentrated ownership can consequently lead to better performance. They argue that there is a positive link between the ownership concentration and corporate governance.

2.2 CORPORATE GOVERNANCE IN KENYA

A number of researches have been done on corporate governance in Kenya but not on establishing whether corporate governance characteristics above have any effect on performance. However, much has focused on general corporate governance issues, (e.g., Jebet (2001), used financial ratios to evaluate quoted firms efficiency in assets utilization and their operating efficiency. Ogoye (2002) on the other hand used ROA and ROE to measure firm performance while examining the effects of executive compensation. Mwangi A.K, (2002) surveyed the

Insurance industry and heavily relied on the Insurance report of 1999. His study focused on ratio analyses of the Insurance companies using performance data mainly from the companies' financial reports.

Codes of governance are designed to mitigate the conflicts of interest, which arise from the separation of ownership from control. The increase in company values in the late 1990s allowed certain practices, which favoured managers over shareholders. These practices were revealed in the subsequent recession post-1999. One clear revelation has been that auditors have lacked the independence needed to discover fraud or questionable accounting in a timely manner, examples being the collapse of Kenya National Assurance and the difficulties of other companies such as Alliance insurance company and other players like MediPlus company.

Besides Kenya, the recent signals of questionable governance include the very high remuneration for chief executives (e.g. Robert Grasso of the NYSE, or Jean-Pierre Garnier of Glaxo SmithKline). Almost all of the world's rich nations introduced codes of conduct in the 1990s to control company directors. In the UK this began with the Cadbury Committee of 1992 and the latest version is the Higgs Report of 2003.

Morck, Shleifer and Vishny (1988) and Barnhart, Marr and Rosenstein (1994) examine the relationship between Tobin's Q and the level of

equity held by the firm's inside directors. However, the Kenya's Insurance sector is owned by individuals, families and institutions either separately or jointly. This to some extent makes it difficult to use market-based performance measures. With only two Insurance companies quoted at the Nairobi Stock Exchange, market value of equity and assets is not available for many of the Insurance companies.

2.3 FIRM PERFORMANCE

Despite a large research effort in the field, there is little consensus as to what aspects of governance really matter. Most codes of governance tend to be prescriptive with little theoretical or empirical underpinning while the findings from the empirical academic research are mixed. Part of this failure to find a robust empirical relationship is attributable to the problems of defining and measuring the performance of companies drawn from a wide range of industrial sectors.

There have been few studies investigating the impact of governance within the mutual fund sector: Tufano and Sevick (1997) on US open-end funds, Barclay, Holderness and Pontiff (1993) and Del Guercio, Dann and Partch (2003) on US closed-end funds. Because bond funds tend to have low annual expenses and small discounts, funds, which hold equities, are more interesting from a governance viewpoint.

The relation between internal aspects of corporate governance and the level of discount is more problematic. Although boards of directors often consider that part of their mandate is to manage the discount, the Del Guercio et al (2003) study does not identify any strong connection. There is also evidence that investor sentiment, measured by retail flows to open-end funds, has a very significant influence on the short-term discount (Gemmill and Thomas, 2002).

Larger discounts are associated with blockholdings held by outsiders. Although this is counter to the results of Del Guercio et al (2003), it is consistent with the results of an earlier US study by Barclay, Holderness and Pontiff (1993). This result suggests that the market view outside blockholders as being friendly to the incumbent management rather than a threat to re-structure the fund. Board focus and director independence is the key elements for fund performance.

2.4 LINK BETWEEN CORPORATE GOVERNANCE AND PERFORMANCE

Because of the difficulty to prove statistically the link between corporate governance and corporate performance, consensus in the literature on this issue cannot be reached. On one edge of the spectrum, some research

studies argue that there is no link between (some aspects of) corporate governance and corporate performance.

Bain and Band (1996) point out that companies and other enterprises with a professional and positive attitude to governance are stronger and have a greater record of achievement. Besides, the Toronto Stock Exchange (1994) has an opinion that there are both a direct and an indirect relationship between corporate governance and corporate performance.

2.5 MEASURES OF PERFORMANCE

The Impact of corporate governance on share prices and valuations was documented in many academic studies. For example, a study of 526 Korean firms by Black, Jag, and Kim (2003) found a 42 percent increase in Tobin's Q if a firm boosts its governance practices. Tobin's Q is measured by dividing the sum of the market value of equity and the book value of debt by the book value of total assets.

It is an important measure of performance in the sense that it represents the value the investors put on the firms shares above the total value of the assets of the firms and thus represents investor confidence, which in turn is an indicator of the effectiveness of the corporate governance mechanisms of the firm. Morck et al (1988) and McConnell and Servaes

(1990) show that the impact of equity ownership may change over levels of ownership.

The return on assets (ROA) is an accounting based measure and is computed from company statement data. The firm's earnings before interest, taxes and depreciation is divided by the average of the book value of total assets at the beginning and ending of the year. It is notable that financial accounting measures do not normally account for shareholder investment risk (Dalton et al. (1998). Observers have suggested that such measure may be seen as more fully under management control (Hambrick and Finkelelstein (1995)

2.6 BOARD SIZE AND CORPORATE PERFORMANCE

Board characteristics such as independence serve as monitoring mechanisms of the firm's management. Less independent boards have decreased monitoring effectiveness because these boards have less impartial members (i.e., top management). This view is generally supported by research, both popular and academic (Hermalin and Weisbach, 2003, McKinnell, 2003). However, alternative views suggest that more independent boards do not serve to strengthen corporate governance (Bhagat and Black [2001]).

Brickley, Coles, and Jarrell [1997] have also documented that the costs may outweigh the benefits in separating the CEO from the Chairman of the Board. Nevertheless, other research studies hypothesize that more independent boards and audit committees are more effective monitors of management.

2.7 OWNERSHIP STRUCTURE AND CORPORATE PERFORMANCE

Extent of firm ownership is another measure of effective monitoring. By keeping virtual control out of the hands of a small number of executives, low levels of managerial ownership contribute to active monitoring (Morck, et al., (1988), Larcker and Richardson (2004). The reasoning follows much of the line of thought as that of independence.

The study by Demsetz and Villalonga (2001) provides recent evidence that there is no significant relationship between ownership structure and firm performance. However, if sufficient monitoring by shareholders or other control mechanisms can not avoid a decrease of profitability, low quality monitors may sell their stakes and new controlling shareholders could improve future corporate performance by substituting incumbent management. Bethel et al. (1998) find empirical support for US

companies where poor corporate performance triggers changes in control to remove top management (Franks et al. (2001).

2.8 CORPORATE GOVERNANCE CHARACTERISTICS

2.8.1 Board size and corporate performance

Many past research documents the effects of the size of the board on performance. Board size can play an important role in the monitoring of management. There has been significant evidence suggesting that smaller boards are more effective monitors than larger boards (Yermack [1996] and Jensen [1993]). Although this is the dominant view in the literature, a case can also be made that firms that have more individual monitors (more board members) are more effective than those that have less.

The best known of the studies on board size is by Yermack (1996). Using Tobin's Q as an estimate of market valuation, he found an inverse association between board size and firm value. The result is robust to numerous controls for company size, industry membership, inside stockownership, growth opportunities and alternative corporate governance structures.

Companies with small boards also exhibit more favorable values of financial ratios. But Dalton and Daily (1998), with their meta-analysis

technique, conclude that larger boards are associated with better corporate financial performance, even when considering the nature of the firm and irrespective of how financial performance is measured.

2.8.2 External Board Members

Studies that do not find a positive link between firm performance and external shareholding include Agrawal and Knoeber (1996), Wahal (1996), Faccio and Lasfer (2000) and Bhagat and Black (2001).

In Dalton (1998), the study finds that it simply does not appear that there is any evidence of the relationship between board composition and financial performance. Nor is there any evidence of relationship between number of directors and the financial performance. On the other edge of the spectrum, some research studies counter-argue that there is a link between the corporate performance and corporate governance.

In addition, in Bhagat and Black (1999), the study finds that there is no convincing evidence that increasing board independence, relative to the norms that currently prevail among large American firms, would improve firm performance.

2.8.3 Individual & family shareholding

Some research studies have found negative relation between ownership concentration and corporate performance. La Porta et al. (1999) have found that when the majority shareholders effectively control corporations, their policies may result in expropriation of minority shareholders by not paying out dividends and transferring profits to other companies they fully own. In addition, Lang and Leslie (2000) have found that the Asian Financial Crisis has been attributed to 'crony capitalism': the control of the companies by a few groups of families. They have expropriated wealth from minority shareholders by setting unfair terms for intra-group sales of goods and services and transfers of assets and control stakes.

Demsetz and Lehn (1985) point out that individuals and families, financial institutions and corporations may have different objectives and monitoring skills. Individual shareholder particularly holding blocks of shares are usually strongly involved with the events of a firm, and therefore their monitoring can enhance the performance of a firm.

2.8.4 Insider shareholding

When insiders have less control of the board, the monitoring of management is of higher quality. Gelb (2000) also posits that when inside

ownership is high, there is less demand for information. Alternative theories state that high inside ownership is beneficial to shareholders because managers have more personal assets at stake in the firm's success (Larcker and Richardson, (2004).

The relation between board ownership and firm value is found to be non-linear with positive influence at lower shareholding levels and negative at higher levels of managerial holdings (Mork et al, (1988); Himmelberg et al, (1999).

2.8.5 Institutional shareholding

The literature that addresses the relation between Institutional shareholding is relatively sparse. Shleifer and Vishny (1986) argue that large shareholders better monitor managers, which in turn increases corporate performance. In their study in 1997, they suggest that the benefits from concentrated ownership may be relatively larger in countries that are less developed, less property rights are not well defined and/or protected and enforced by judicial systems.

Corporate governance is also shown to strengthen with high levels of institutional ownership. These institutional shareholders act as external monitors (Shleifer and Vishny, (1997), Larcker and Richardson, (2004).

Some research suggests greater ownership by institutions can contribute to corporate governance because these large outside investors serve as active monitors (see Larcker and Richardson [2004], and Shleifer and vishny [1997].

Honderness and Sheehan (1988), and Barclay and Holderness (1989) also support the argument that large shareholders better monitor management and thereby improve corporate performance. In sum, the studies on this edge of the spectrum have found a positive relation between ownership concentration and corporate performance.

Financial institutions on the other hand have skills and resources to monitor managers but they can also influence mangers in order to push their own agenda in the firm.

CHAPTER 3: RESEARCH METHODOLOGY

3.1 RESEARCH DESIGN

The study sought to establish whether there exist any significant relationship between corporate governance and Performance of Insurance Companies in Kenya. To test the stated relationship, a basic regression model of the form: Performance = f (corporate governance variables, control variables) was used. ROA (the dependent variables) is used to measure performance. To represent corporate governance, board characteristics and ownership characteristics are used. The control variable used is the firm characteristic, which in this case is FIRSIZE (Firm size).

3.2 SAMPLING DESIGN

The population for this study comprised of all the insurance companies in Kenya that operated in Kenya between 1st January 1999 and 31st December 2003. 33 out of 39 Insurance companies that were operational over that period formed the sample. (See appendix i). The difference was those companies whose data was not readily available hence left out.

3.3 DATA COLLECTION

Performance and size data for the Insurance companies were taken from the records of the Commissioner of Insurance together with some

companies' corporate governance data. The corporate governance and performance as well as the firm size data were also collected directly from a handful of insurance companies.

The corporate governance characteristics were used as the independent variables. This research used the widely used corporate governance characteristics of a firm, usually grouped under board structure and ownership structure categories.

3.4 VARIABLE SPECIFICATION AND MODEL

The following regression equation was used to estimate performance;

$$\textbf{Performance}_{i,t} = \beta_0 + \beta_1 \textbf{BDSIZE}_{i,t} + \beta_2 \textbf{EXTBD}_{i,t} + \beta_3 \textbf{INDBLK}_{i,t} + \beta_4 \textbf{INSBLK} + \beta_5 \textbf{INDUSBLK}_{i,t} + \beta_5 \log \textbf{(FIRSIZE)}_{i,t} + \varepsilon_{i,t}$$

Where i and t are the 33 Insurance companies and the 5-year period respectively. ϵ is an error term.

The variables used in the analysis are defined as follows:

Board size (BDSIZE) is defined as the total number of board Members. It is the sum of the entire executive as well as the non-executive directors.

External Board (EXTBD) is defined as percentage of external board members. These are directors who are non-executive or not members of the managerial board of the firm in question.

Individual & Family (INDBLK) means the percentage of common shares owned by individual & Family members

Inside (INSBLK) is defined as the Percentage of common Shares owned by insiders

Industrial (INDUSBLK) is defined as the Percentage of common shares owned by industrial firms

Return on assets [ROA] is defined as the Earnings before interest, taxes & Depreciation divided by the book value of total assets expresses as a percentage. Return on Assets is the performance measures, which is the dependent variables in this research. The return on assets (ROA) is an accounting based measure and was computed from financial statements data. The total assets were averaged in the successive years to smoothen any anomalies.

The firm size (FIRSIZE) is defined to mean the book value of total assets. The natural logarithm of the book value of total assets was used in the regression analysis to account for inherent skewness of this variable. Firm characteristic, although not of primary interest, was included here as a control variable because differences on the size of firms in terms of the

book value, can affect the relative performance of the firm. In this case therefore, the book value of total assets of a firm was used as a measure of the size of the firm.

3.5 DATA ANALYSIS

In line with the objective of this study, the analysis examined whether corporate governance of Insurance companies in Kenya has any relationship with their performance (measured over 1999-2003)

Data was analyzed on the basis of descriptive statistics. This involved establishing the mean, median and standard deviation as well as the first quartile and the third quartile that describe the lower and the upper values of a variable.

Since this study is to establish whether there is or there is no relationship between corporate governance structures and performance, there was need to test this relationship statistically, data was analyzed using the multiple regression model above. The model was selected due to its suitability in examining the effect of several variables through the use of such test as t-statistic, multiple correlation coefficient, confidence intervals and F-statistic among others. The analysis involved regression of corporate performance on corporate governance and each of the 33 firms-specific variables for the five-year period. Pearson correlation test

which is appropriate for interval and ratio scaled variables was used to examine the variable for correlation and it was used to find out the level of statistical significance. The resultant data formed the basis of the study's conclusions.

3.6 HYPOTHESIS

To study whether corporate governance characteristics which were used in this research, number of directors, external board membership (non-executive directors), individual & family holding, insider holding and institutional holding of board and ownership structures are related to performance, there was the need to test the null hypothesis namely;

Ha: There is no relationship between corporate governance characteristics and performance of the insurance companies in Kenya

CHAPTER 4:RESEARCH FINDINGS

4.1 DESCRIPTIVE STATISTICS

Table 1 shows the descriptive statistics for the period 1999 through 2003. With the number of Insurance companies at 33, the results of table 1 panel A show that on average the firms have a mean of 6 directors. Only 14 firms (see appendix1) out of the 34 sampled firms had lower than the mean number of directors. It can be observed that the mean and median of the number of directors are not significantly different.

Table 1. Descriptive statistics for Corporate Governance

The sample consists of 33 insurance companies. Annual data for a five-year period are analyzed. All variables are defined in section 3.4. *Firsize* is the natural log of the size of the firm.

Panel A. CORPORATE GOVERNANCE CHARACTERISTICS						
	Mean	**Median**	**25th**	**75th**	**St. dev.**	**Observations**
BDSIZE	6.3529	6	5	7	1.47792	33
EXTBD	65.7941	72	57	80	29.0963	33
INDBLK	56.0882	50	14	100	38.3508	33
INSBLK	13.8029	0	0	30	20.6745	33
INDUSBLK	34.5320	50	0	76.8	38.1853	33

Panel B. FIRM CHARACTERISTICS						
	Mean	**Median**	**25th**	**75th**	**St. dev.**	**Observations**
FIRSIZE KshsM	1568.4	691	425	1954	2148.28	33

Panel C. PERFORMANCE						
	Mean	**Median**	**25th**	**75th**	**St. dev.**	**Observations**
ROA (%)	9.4123	5.0525	2.37	10.2	19.1547	33

It is clear from table 1 panel A that there are a high number of non-executive representations with their numbers at a mean of 65%. With a median of 72%, it shows there are small differences in the percentage of non-executive directors on boards. This indicates that, on average, most Insurance companies embraced the idea of non-executive directors in their boards, which may make it more difficult for the insiders to influence plans with which the non-executive did not agree.

As a benchmark, values for these variables found in prior research and not yet researched in Kenya, the median board size ranged from 11 to 13 directors (see appendix 1) while the mean percentage of external board was from 56% to 69% (Aggarwal and Nanda [2004], Klein [2002a], Core et al. [1999]). Thus the mean number of directors differs significantly

while the mean of external board of my sample is comparable to those findings.

Looking at the individual members who hold shares in insurance companies, the mean of 56% shows many companies are held by individuals. The median of 50% attests to that. Only four companies are fully held by institutions while 11 (see appendix 1) are fully held by individuals and a significant number of the difference are held by individuals hence a 14% 1st quartile and 100% 3rd quartile. The median value of 50% doe 0.581686 s not differ much from the mean.

The extent of ownership is measured here by the percentage of the insiders' holdings. From table 1, the mean is 13% with a median of 0. This result shows that very few firms, infact twelve of them had shares held by insiders, a majority of whom held 50% and below. Only one firm out of the twelve firms had 72%, i.e, above the 50% of the insiders holding of shares. By keeping virtual control away from the small number of executives, this result may be said to go past study assertion that, Low level of managerial ownership contribute to active monitoring (Morck et al., [1988], Larcker and Richardson [2004]).

As a benchmark, values of variables found in prior research had mean values of insider holding of between 3.5% and 16% (Larcker and

Richardson [2004], Yermack [1996]) and mean institution holding of between 44% and 58% (Larcker and Richardson [2004], Richardson et al. [2004]). With a mean of 13% of insider holding and a mean of 34% of institutional holding, the latter does not compare very well with these findings but the earlier does.

With regard to the firm size as shown in table 1 panel B, it is observed that the mean is Kshs 1,568.4 while the median is Kshs 691. This is evidence of a significant variance between the big and small firms. Many firms are worth Kshs 500M and below. Only a few firms, eleven out of the sampled 33, (see appendix 1) had assets worth over shs 1,000 m.

4.2 SIMPLE CORRELATIONS

Table 2 presents results of a simple correlation analysis of all variables used in the analysis. Performance is positively but not significantly correlated with Insider holding, Institutional holding and firm size: and negatively and again not significantly correlated with number of directors, external board and individual shareholding.

Table 2. Correlation Matrix for Corporate Governance

See section 3.4 for variable definition. *Firsize* is the natural log of the size of the firm. Sample consists of 33 insurance companies. Pearson correlation has been used.

	BDSIZE	EXTBD	INDBLK	INSBLK	INDUSBLK	FIRSIZE	ROA
BDSIZE	1	0.0275	-0.2363	-0.1461	0.25394	0.40974	-0.2156
EXTBD	0.0275	1	-0.2214	-0.1129	0.20096	0.21928	-0.0639
INDBLK	-0.2363	-0.2214	1	0.3511	-0.93148	-0.49705	-0.2068
INSBLK	-0.14613	-0.11295	0.3511	1	-0.31386	-0.14438	0.0410
INDUSBLK	0.25394	0.2009	-0.9314	-0.3138	1	0.48652	0.11080
FIRSIZE	0.40974	0.2192	-0.49704	-0.1443	0.48652	1	0.08237
ROA	-0.21565	-0.0639	-0.2067	0.0414	0.11080	0.08237	1

4.3 REGRESSION RESULTS

Regression Results are presented in Table 3. It is observed that four coefficients, i.e., Number of directors, external board, Individual holding and the institutional holding are negatively related to Return on investment. Insider holding and Firm size are positively related to Return on investment. The results show that the return on investment is positively influenced only by the insider holding as a corporate governance variable, while all the other variables are negatively related with return on investment but significantly positively related with the size of the firm, the control variable.

Table 3. Regression

See section 3.4 for variable definition. *Firsize* is the natural log of the size of the firm. Sample consists of 33 insurance companies. Pearson correlation has been used.

Regression Statistics	
Multiple R	0.4388272
R Square	0.1925693
Adjusted R Square	0.0131403
Standard Error	11.997497
Observations	34

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*95% Conf.*	*Interval*
Intercept	42.081657	19.43517	2.165231	0.039373	2.203995	81.9593
BDSIZE	-2.358972	1.542904	-1.528916	0.137917	-5.524748	0.80680
EXTBD	-0.055678	0.073446	-0.758079	0.454970	-0.206378	0.09502
INDBLK	-0.256153	0.151834	-1.687052	0.103115	-0.567690	0.05538
INSBLK	0.0619928	0.107008	0.579328	0.567170	-0.157569	0.28155
INDUSBLK	-0.181086	0.149103	-1.214498	0.235073	-0.487021	0.12484
FIRSIZE	0.9809036	1.759035	0.5576371	0.581686	-2.628336	4.59014

4.4 NUMBER OF DIRECTORS

Table 3 shows that the variable representing the number of directors show a negative coefficient hence a negative relationship with the performance measure and is statistically significant at 5%. These results suggest that firms with small boards have better performance.

Board size can play an important role in the monitoring of management. There has been significant evidence and conjectures suggesting that smaller boards are more effective monitors than larger boards (Yermack [1996] and Jensen [1993]).

The negative relationship between the number of directors and the performance measure provide only limited support for the view that the number can influence performance. The results somehow clearly indicate that as the number of directors is increased, that would really translate to the company making lower profits. It would probably be more appealing to have a larger board if the firm is large but have it consist of a high percent of about 60% or more as external members.

To effectively monitor and make decisions suitable for improved performance, it requires that the board be cohesive. Large groups are associated with communication and Coordination problems [Haleblian & Finkelstein, 1993]. These problems can translate to reduced investment competitiveness, which can lead to poor performance. The results herein therefore reveal a negative relationship between the size of the board and performance and in this case, the size of the board matters. The correlation between the number of directors and performance is negative at 21%. It means that the larger the board the lower the returns. Knowing

that large boards may mean more expenditure, expenses have an important influence on returns. Therefore, the size and characteristics of the board of directors can influence performance on account of expenses.

Overall, the empirical findings suggest that small boards with a large proportion of outside directors would be more effective monitors of management and therefore increase company value. These results are consistent with the general literature that small boards perform better (such as Yermack, 1996 and Eisenberg, 1998). Even so, there is no evidence that increased external board members representation has a positive effect on firm performance.

4.5 EXTERNAL BOARD

External board is negatively related to the performance measure suggesting that the effect of external boards do not have capturing effect on Performance. The correlation between External board and performance as depicted in Table 2 is negative. This indicates that when the external board membership is comprised of external directors, less of better performance is realized and vise versa.

Other research have concluded that a board that has a majority of external directors provide links with different sectors [Pfeffer & Salancik, 1978;

Zahra & Pearce, 1989] or infusion of ideas to the advantage of a firm's performance from the diversity of directors from outside the firm. The regression results show that the percentage of external directors is negatively related with performance.

These results reflect that in Kenya, it appears that inside director for Insurance companies have a positive impact and outside directors a negative impact and is therefore not consistent with conventional wisdom that outside directors have a positive impact on performance which has not always been supported in empirical studies before (e.g. Agrawal and Knoeber, 1996; Yermack, 1996; Hermalin and Weisbach, 2003). However, researchers have not been able to observe any systematic and significant effects of external directors on performance [Dalton et al., 1998]. This research although different from the past research (not done in Kenya) may mean that inside directors provide the insurance firms with knowledge of operations and ability to integrate that help them make better operation and technical decisions to exploit their capabilities that translate to better performance.

4.6 INDIVIDUAL & FAMILY HOLDING

The investors may be institutional investors or individuals. What they have in common is that they are long term holders and may posses the

detailed knowledge of the firm and its markets necessary to add value as a monitor. Notable also is the positive correlation between the institutional shareholding and the size of the firm. Which indicates that as the former shareholding increases, the latter also increases. The opposite, i.e., individual shareholding is negatively correlated with the firm size and therefore conforms to the same argument because the lower the individual shareholding the larger the firm.

The pair of Individual & family shareholding and insider shareholding was expected to have a negative effect on performance. The results actually show a negative relationship between individual & family holding and performance as expected and thus significant at the 5% level (see table 3).

Ferris et al (2003) found that having external directors is good for company performance. Although their findings found that having external board members is good for performance but having seats on boards of related (family) companies is bad for performance, I find that their findings on the latter (Individual & family holding) are consistent with these results. The correlation between the performance measure and individual &family holding apparently is negative as shown on table 2.

4.7 INSIDER HOLDING

Similar significant differences are found when the impact of insider shareholders is analyzed. As table 3 shows insider shareholding has a high positive relationship with performance. Here it is observed that the insider holding coefficient is positive. This result is consistent with the convention agency wisdom, which suggest that high managerial holding should bond the managerial actions to shareholder interests [Jensen & Murphy, 1990]. Insider holding can motivate Insiders who manage a company to compete and invest strategically for the benefit of the firm in terms of profits.

The correlation between performance and Insider holding is positive hence supporting the view that when the insider holding increases, the performance get better. It therefore reflect that increased insider ownership by the insurance companies may have been driven by the desire to motivate those inside to effectively achieve the better performance objective.

4.8 INSTITUTIONAL HOLDING

Institutional shareholding has a negative relationship with performance. The regression results shown in table 3 indicate the relationship, which indicate that an insurance company with a higher institutional directorship structure does not produce better performance.

Institutional investors have been said to have strong incentives to monitor their firms in an effort to ensure that decisions of value that bring about higher returns are made [Johnson & Greening, 1999, Pound, 1992]. The results herein do not correspond with this rationale but contradictions in research do happen and as is revealed by these results, the institutional holding does not necessarily bring with it enriched ideas, consensus coordination capabilities as would be done by individual directors.

CHAPTER 5: CONCLUSIONS, LIMITATIONS AND RECOMMENDATIONS

5.1 CONCLUSIONS

This paper is a first attempt to analyze the effect of corporate governance on corporate performance of Insurance companies in Kenya. A number of past research not done in Kenya not necessariyly on insurance companies, have suggested that the board structures which include the board size and the number of external directors should have a negative and positive relationship respectively with performance so that when the number of directors is small and when the number of external directors is high, performance is improved.

1. This research find evidence that the size of the board and insider holding on one hand have an association with performance but does not find any evidence that external board, individual holding and institutional holding have any influence on performance.

2. These results therefore suggest that the governance structures which were used, number of directors, external board membership (non-executive directors), individual & family holding, insider holding and institutional holding had a mix of the expected impact on firm performance.

There are a number of possible reasons for this.

First, it appears that the general adoption of specific governance structures may not be appropriate for all insurance companies. The governance factors used in this research may therefore only be beneficial in certain circumstances.

Secondly, the size of an insurance company did not necessarily match the size of the board neither did it mean that institutional shareholders either hold it or not.

5.2 LIMITATIONS OF THE STUDY

The main limitation was the lack of data from a number of insurance companies themselves who out rightly refused to cooperate. Although the Commissioner of insurance gave data, there was no consistency in data for some companies while there was none at all for others. However, 33 out of 39 companies was a good representative hence insignificant negative effects if any on the accuracy of results.

Another limitation of the research included the investigation using one control variable, i.e., the size of the firm. Nevertheless, at the practical level these findings gave a valuable stimulus of the direction it would take to examine corporate governance effects on performance of insurance companies in Kenya.

5.3 RECOMMENDATIONS FOR FURTHER RESEARCH

This research has exposed some of the effects of governance on insurance companies' performance, but there is much more to be discovered if the future empirical tests are based on a larger data set from many corporate governance mechanisms and more control variables as well as including performance trends.

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APPENDIX i DATA USED IN THE ANALYSIS

Firm	No. of directors	% ext board	% Individual holding	% insider holding	% Institutional holding	log (FIRSIZE)	ROA Kshs M
Kenindia	9	28%	45	0	55	8.289108	16.86788
AIG Kenya ltd	5	60%	33	0	67	8.801719	7.034919
UAP	8	100%	12	0	88	7.621278	15.12908
Heritage	8	100%	0	0	100	7.803511	10.26812
Madison	4	67%	80	40	20	7.38197	4.45322
Kenya Alliance	5	80%	20	0	80	7.609924	2.533775
ICEA	7	86%	0	0	100	9.228883	2.960409
Jubilee	9	78%	40	5	60	8.474902	8.17459
Lion	7	100%	0	0	100	7.521249	17.23336
APA	7	100%	20	0	80	7.710923	5.746116
Invesco	6	76%	100	50	0	5.624988	8.679378
Standard	3	30%	10	0	60	5.971471	55.58871
Blue Shield	6	67%	50	42	50	6.727927	1.206796
Occidental	6	100%	40	40	60	6.551226	5.363771
Royal	6	80%	100	0	0	6.24635	6.681353
First Assurance	6	67%	100	0	0	6.499194	8.197261
Concord	5	60%	100	0	0	5.818368	2.896065
Phoenix	9	78%	100	0	0	6.669636	3.588153
Fidelity Shield	5	90%	100	0	0	6.51731	4.501399
Tausi	6	0%	100	0	0	5.718944	4.12281
Intra Africa	6	0%	80	20.5	20	6.517434	3.284595
Mercantile	5	80%	50	0	0.5	6.242209	7.113405
Genral Accident	6	83%	100	30	0	6.649192	18.2278
Trident	5	80%	10	0	99.99	6.200544	9.234907
Gateway	7	28%	100	72	0	6.41609	4.756118
Corporate	7	56%	40	0	60	6.183977	2.202099
Cannon	5	20%	75	33	67	6.707362	3.793543
Amaco	5	80%	100	50	0	3.375808	-1.65625
Kenya Orient	5	80%	12	1.8	98	5.376319	6.12873
Monarch	5	67%	70	0	30	5.418583	10.15952
Old Mutual	7	60%	10	30	50	7.809351	8.699662
CIC	9	0%	0	5	95	6.328057	6.025283
Pioneer	5	60%	70	50	30	6.225059	50.82205
Trinity	5	40%	100	0	0	1.158603	0

APPENDIX ii DATA REQUEST SHEET

A) Corporate Governance Measures

Board details

- Chairman also the CEO [Yes/No]
- Total no. Of directors……..
- Permanent board or Appointed by rotation……

***1.* Structure of the board**

- Number of Insider directors……...
- Number of outside directors……..
- Presence of family members in board (Yes/No)……..
- Presence of institutional/firms holding [Yes/No]……

***2.* Shareholding**

- Number/Percentage of external board members……..
- Number/Percentage of common shares held by individuals……..
- Number/Percentage of shares held by family members……..
- Number/Percentage of shares held by insiders……..
- Number/Percentage of shares held by institutions/firms……..

B) Company performance in the last 5 years

	1999 KShs M	2000 KShs M	2001 KShs M	2002 KShs M	2003 KShs M
Earnings before Interest and depreciation					
Interest					
Depreciation					
Taxes					
Net Profit after Taxes					

C) Company financial status in the last 5 years

	1999 KShs M	2000 KShs M	2001 KShs M	2002 KShs M	2003 KShs M
Fixed Assets					
Current Assets					
Total Assets					
Current Liabilities					
Long Term Liabilities					
Total Liabilities					
Net Assets					
Share Capital					
Reserves					
Total Shareholders funds					

APPENDIX iii LIST OF INSURANCE COMPANIES

1. African International Insurance
2. American Life Insurance Company (K) Ltd.
3. Apollo Insurance Co. Ltd.
4. Blue Shield Insurance Company
5. British American Insurance Company Ltd.
6. Cannon Assurance (K) Ltd.
7. Concord Insurance Co. Ltd.
8. Co-operative Insurance Services Ltd.
9. Corporate Insurance Company Ltd.
10. Fidelity Shield Insurance Company Ltd.
11. First Assurance Co. Ltd.
12. Gateway Insurance Co. Ltd.
13. Geminia Insurance Co. Ltd.
14. General Accident Insurance Company of Kenya
15. Insurance Company of East Africa Ltd.
16. Intra Africa Assurance Company Ltd
17. Jubilee Insurance Co. Ltd.
18. Kenindia Assurance Co. Ltd.
19. Kenya Orient Insurance Company Ltd.
20. Kenya Reinsurance Corporation
21. Lion of Kenya Insurance Company Ltd.
22. Madison Insurance Company (K) Ltd.
23. Mercantile Life and General Insurance Company
24. Monarch Insurance Company Ltd.
25. Occidental Insurance Company Ltd.
26. Old Mutual Insurance Co.

27. Pan African Insurance Company Ltd.
28. Phoenix of E.A. Insurance Co. Ltd.
29. Pioneer General Assurance Society
30. Provincial Insurance Co. of E.A. Ltd.
31. PTA Reinsurance Co.
32. Royal Insurance Company of E.A. Ltd
33. Standard Assurance Kenya Ltd.
34. Tausi Assurance Co. Ltd.
35. The Heritage A.I.I. Insurance Co. Ltd.
36. The Kenyan Alliance Insurance Co. Ltd.
37. Trident Insurance Company of Kenya Ltd.
38. UAP Provincial Insurance Co. Ltd.
39. United Insurance Co. Ltd.