# A SURVEY OF CORPORATE GOVERNANCE PRACTICES OF BANKS IN KENYA

BY

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## DECLARATION

I declare that this research project is my original work and it has never been submitted to any other institution for any award.

**SIGNED:**........................................................ **DATE:** 24-11-06

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This is to certify that this research project has been submitted with my permission and authority as the university supervisor.

Supervisor

**SIGNED:**........................................................ **DATE:** 24-11-06

**MR. LISIOLO LISHENGA**

## DEDICATION

This research project is dedicated to my loving wife Dorcas and our two daughters Fiona and Briege whose encouragement and understanding made this onerous task look simple.

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**ABSTRACT**

Corporate governance has become an issue of global significance. The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations. Following the financial crisis of the latter part of the 1990's the issue of corporate governance has gained prominence internationally and Kenya has not been left behind. Kenya has had its fair share of collapse of financial institutions in the last decade.

This research paper examines the corporate governance practices in the banking industry in Kenya and the survey shows an awareness and existence of corporate governance practices. It further illustrates the need to strengthen these practices owing to the special nature of banking with a diversity of stakeholders.

The empirical findings of this paper are consistent with the guidelines developed by the capital markets authority and the prudential guidelines issued by the central bank of Kenya. They also relates to practices recommended by other jurisdictions outside Kenya like the Basel Committee on Banking Supervision, the guidelines by the Commonwealth association for corporate governance and the organization for economic cooperation and development.

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# SECTION ONE

## 1.0 INTRODUCTION

### 1.1 Background of the Study

In broad terms corporate governance refers to the process by which organizations are directed. controlled and held accountable. It encompasses authority, accountability, stewardship. leadership. direction and control exercised in organizations. Corporate governance is a concept that involves practices that entail the organization of, management and control of companies. It reflects the interaction among those persons and groups, which provide resources to the company and contribute to its performance such as shareholders, employees. creditors. long-term suppliers and subcontractors (Brownbridge, 1997).

Corporate governance has become an issue of global significance. The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations. Following the financial crisis of the latter part of the 1990's the issue of corporate governance has risen to the head of the international agenda as an important component of the global financial architecture. The collapse of big organizations has cast doubts in the way corporations are managed and made accountable.

#### 1.1.1 Corporate governance in banks

In the last two decades of the $20^{th}$ century over 130 countries, comprising almost three fourths of the member countries of the International Monetary Fund (IMF) have experienced significant problems with their banks (Lindgren, Garcia and Saal, 1996). The fact that these crises occurred after implementation of far reaching reforms of financial systems revived the long standing debates in Finance and Economics on the role of bank regulation (Mishkin, 1992; McKinnon. 1993). Notably absent in the debate, however is consideration of the corporate governance of banks.

The unique governance dilemmas confronting the bank's owners. depositors and the regulator may explain why there has been very little research – either empirical or theoretical- on their corporate governance. The extant literature on banks is even limited by the unqualified application of the standard Agency Theory of the firm to banks, which assumes that banks operate in the same type of competitive markets and are structured managerially by the same forces as all other firms. According to Ciancanelli and Gonzalez (2000), such assumption is completely at odds with the empirical reality requiring that banks be regulated. This fact alone makes it untenable to assume competitive markets for banks and thus changes the nature of bank' corporate governance.

In order to illustrate the lack of fit between standard agency models and banks, Ciancanelli and Gonzalez (2000) review assumptions of standard agency theory and compare them with bank characteristics. Agency theory makes three assumptions: markets are competitive; the nexus of information asymmetry is the principal- agent relationship between owners and managers; and, that optimal capital structure requires limited gearing. In contrast one finds that commercial banks have three unique features: they operate in regulated or administered markets; the agency problems facing them are more complex; and, capital structure is highly geared with owners rarely providing more than 10% of loaned capital (bond holders and depositors provide the rest). From governance perspective complications occur for banks because of the existence of three additional loci of asymmetric information in banks. In addition to information asymmetry between managers and owners, there is asymmetry between the following: depositors, the bank and the regulator; owner, managers and the regulator; and, borrowers, managers and the regulator.

It is clear that corporate governance in banks is different because of the intervention of regulation. Freixas and Rochet (1997) suggest that regulation has at least four effects. Firstly, the existence of regulation implies the existence of an external force, independent of the market, which affects both the manager and the owner. Secondly, because the market in which banking firms act is regulated, regulations create an external governance force on the banks. Thirdly, the existence of both the regulator and regulations implies that market forces will discipline managers and owners in a different way than in unregulated firms. Fourthly, in order to prevent systemic risk, such as lender of last resort, the current banking regulation means that a second and external party is sharing the banks' risk.

The banking system acts as the medium through which national savings are mobilized for development. The banks do this by providing safe custody for depositors' money and disbursement of loans for development. Through this system, national savings are accumulated and invested in productive sectors of the economy, leading to national wealth creation in a broader context. Indeed, the bulk of the money that banks give as loans to investors is from such depositors. It is on the basis of high level of trust that depositors keep their money in the bank hoping to collect it at their convenience whenever need arises. The mobilization of savings is crucial in national economic activities since it is these savings that are invested to spur economic growth. A high savings rate is therefore vital to the growth of any economy as it provides vital resources for investment.

It is worth noting however, that despite the Kenya government's efforts to streamline the banking sector by introducing statutory regulatory measures, more banks, 33 to be precise, have been liquidated or put under receivership in the period that followed the introduction of these control mechanisms. During this period, more banks collapsed due to weak internal controls and bad governance and management practices. For instance, the Continental Bank of Kenya Limited and Continental Credit Finance Limited collapsed in 1986, Capital Finance Limited collapsed in 1987, seven banks, which had collapsed, were merged in to form the Consolidated Bank of Kenya limited in 1989, thirteen banks collapsed in 1993 and five banks collapsed between 1996 and 1999. In 1999 Trust Bank, the sixth largest bank in Kenya – in terms of deposits - collapsed due mainly to insider lending to directors and shareholders. The most recent bank failure was witnessed in June 2006 when Charter House Bank, was placed under statutory management.

It is argued that that the major reasons for the collapse of most of the banking institutions in Kenya could be attributed to weak corporate governance practices, poor risk management strategies, lack of internal controls, weaknesses in regulatory and supervisory systems, and insider lending and conflict of interest (Centre for Corporate Governance, 2004).

Good corporate governance practices in the banking industry is imperative if the industry is to effectively play a key role in the overall development of Kenya. Specifically, it is expected that good corporate governance practices in the banking sector will spur confidence among the investing public, expand the range of banks' services, expand the band of savers and borrowers, and reduce high cost of administration of debts.

## 1.2 Statement of the Problem

Corporate governance has become an issue of global significance. The globalization and liberalization of economies has presented both challenges and opportunities for African countries. As expressed by Littlefield (2003), the need to strengthen corporate governance has become critical for promotion of sustainable development and self-dependence on the continent of Africa.

In Kenya, there is a need for good governance, especially in the banking sector. Kenya has had a serious crisis in the last two decades in the banking sector, where thirty-three (33) banking and non-banking institutions folded their businesses. It is important to determine the main causes of the failure of these banks.

The role that the Central Bank plays to ensure adequate supervision, enforcement of banking laws and prudential regulations by the financial institutions-both formal and informal, commercial banks and MFIs needs to be understood (CBK, 2001).

Choudhury and Ahmed, (2002); Keohane, (2002), and Kim, (2003), observes that, although the emergence and legitimacy of banks in democratic governance has been well documented, little research has explored appropriate types and practices of accountability in these banks.

In particular, little has been done to examine these topics in the comparative text. Discussions on the growing number of banking institutions and their roles in provision of finance to the Kenyan business community are not complete without an examination of accountability relationships. In particular, one needs to examine the internal and external relationships among the bank's management, board of directors or trustees, government agencies, donor-serviced communities and other stakeholders, Kim (2003). Although corporate governance might be a conscious practice in the private and public sector, it is not evident as to whether and to what extent it is practiced by the banking institutions in Kenya.

Prior research on corporate governance in Kenya has focused mainly on compliance with/or the state of the principles of corporate governance and best practices: Jebet (2001), on the corporate governance structures prevalent in public companies; Kitonga (2002) on the need for corporate governance audit in Kenya; Mwangi (2002) on corporate governance practices in the insurance industry in Kenya; Mucuvi (2002) on corporate governance practices in the motor vehicle sector in Kenya; Wainaina (2002) on corporate governance practices in the micro-financial institutions; Gakuo (2003) on corporate governance practices in non-governmental organizations; Wangombe (2003) on corporate governance practices in cooperative SACCOs in Nairobi; and Mwangi (2003) on the determinants of corporate board composition.

The only local study on the banking sector was carried out by The Centre for Corporate Governance (2004) but was restricted to only 10 of the biggest banks in Kenya.

The presence and quality of governance at all levels in an organization, is increasingly being seen as important in the success of organizations as it helps them to be sustainable.

## 1.3 Objectives of the Study

The main objective of this study is to provide an analysis of the corporate governance practices among commercial banks in Kenya, with special emphasis to banks operating in Nairobi. The study seeks to determine the corporate governance procedures applied in the banking sector.

### 1.4.1 Research Questions

The proposed study intends to answer the following research questions;

1. What is the nature and characteristics of corporate governance systems in commercial banks in Kenya?
2. To what extent and prevalence is the use of selected corporate governance practices in Kenyan commercial banks?

## 1.5 Significance of the Study

The study is important to different authorities;

The Central Bank of Kenya as a regulatory authority to assess the current and future expectations of industry players in banking can use the findings of this study. This will help in examining the role that corporate governance plays in the industry.

The study will aid the commercial banks in Kenya, as they will get an insight as to the role of corporate governance especially in issues of transparency and accountability and social responsibility.

## 1.6 Scope of the Study

The study targeted all the 45 commercial banks with head offices in Nairobi. However due to the limitation in resources and time, the researcher conducted a sample survey, which covered more than 50% of the population.

## SECTION TWO

## 2.0 LITERATURE REVIEW

### 2.1 Corporate Governance

According to McCord (2002), corporate governance refers to the manner in which the power of a corporation is exercised in the stewardship of the corporation total portfolio and resources with an objective of obtaining increasing stakeholders value with a satisfaction of other stakeholders within the context of individual organizations corporate mission and vision as spelt out in the strategic plan of an institution. Governance refers to the manner in which power is exercised in the management of economic and social resources for sustainable human development initiative (McCord, 2002). In today's world, Governance has assumed critical importance in the socio-economic and political systems.

The Basel Committee on Banking Supervision (1999) states that from a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:

i. Set corporate objectives (including generating economic returns to owners);
ii. Run the day-to-day operations of the business;
iii. Consider the interest of recognized stakeholders;
iv. Align corporate activities and behaviours with the expectation that banks will operate in safe and sound manner, and in compliance with applicable laws and regulations; and,
v. Protect the interests of depositors.

The Committee further enumerates basic components of good corporate governance to include:

a) The corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;
b) A well articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;

c) The clear assignment of responsibilities and decision making authorities, incorporating hierarchy of required approvals from individuals to the board of directors;

d) Establishment of mechanisms for the interaction and cooperation among the board of directors, senior management and auditors;

e) Strong internal control systems, including internal and external audit functions, risk management functions independent of business lines and other checks and balances;

f) Special monitoring of risk exposures where conflict of interests are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management or key decisions makers within the firm (e.g. traders);

g) The financial and managerial incentives to act in an appropriate manner, offered to senior management, business line management and employees in the form of compensation, promotion and other recognition;

h) Appropriate information flows internally and to the public.

King and Levine (1993a and b) and Levine (1997) emphasize the importance of corporate governance of banks in developing economies and observe that the importance is because:

- First, banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth.
- Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms.
- Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy's savings.
- Fourth, many developing economies have recently liberalized their banking systems through privatization/disinvestments and reducing the

role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.

Banking supervision cannot function if there does not exist what Hetteš (2002) calls "correct corporate governance" since experience emphasizes the need for an appropriate level of responsibility, control and balance of competences in each bank. Hetteš expounds further on this by observing that correct corporate governance simplifies the work of banking supervision and contributes towards co-operation between the management of a bank and the banking supervision authority.

Crespi *et al* (2002) contend that corporate governance of banks refers to the various methods by which bank owners attempt to induce managers to implement value-maximizing policies. They observe that these methods may be external to the firm, as the market for corporate control or the level of competition in the product and labour markets and that there are also internal mechanisms such as a disciplinary intervention by Shareholders (what they refer to as *proxy fights*) or intervention from the board of directors.

## 2.2 The Need for Good Corporate Governance

Good Corporate Governance aims at increasing profitability and efficiency of organizations and their enhanced ability to create wealth for shareholders, increased employment opportunities with better terms for workers and increased benefits to stakeholders. The transparency, accountability and probity of organizations make them acceptable as caring, responsible, honest and legitimate wealth creating organs of society. The enhanced legitimacy, responsibility and responsiveness of business enterprises within the economy and improved relationships with their various stakeholders comprising shareholders, managers, employees, customers, suppliers, host communities, providers of finance and the environment enhance their market standing, image and reputation (PSCGT, 2002)

The global corporate governance forum notes in its mission statement that Corporate Governance has become an issue of worldwide importance.

The Corporation has a vital role in promoting economic development and social progress. It is the engine of growth internationally and increasingly responsible for providing employment, public and private services, goods and infrastructure.

The efficiency and accountability of the corporation is now a matter of both private and public interest and governance has thereby come to the head of the international agenda (The Pan African Consultative Forum on Corporate Governance, 2004).

The Commonwealth Association for Corporate Governance in its publication "CACG guidelines Principles for Corporate Governance in the Commonwealth states that the globalization of the market place within this context has ushered in an era where the traditional dimensions of corporate governance defined within local laws, regulations and national priorities are becoming increasingly challenged by circumstances and events having an international impact (The Pan African Consultative Forum on Corporate Governance, 2004).

Good corporate governance is necessary in order to attract investors both local and foreign and assure them that their investment will be secure and efficiently managed and in a transparent and accountable process, create competitive and efficient companies and business enterprises, enhance the accountability and performance of those entrusted to manage corporations and promote efficient and effective use of limited resources (Ledgerwoods, 1981).

Without efficient companies or business enterprises the country will not create wealth or employment. Without investment, companies will stagnate and collapse. If business enterprises do not prosper there will be no economic growth, no employment, no taxes paid, and invariably the country will not develop. The country needs well-governed and managed business enterprise that can attract investment, create jobs and wealth and remain viable, sustainable and competitive in the global market place. Good corporate governance therefore becomes a prerequisite for national economic development (Ledgerwoods, 1981).

## 2.3 Principles of Good Corporate Governance

The Private Sector Corporate Governance Trust (PSCGT) (2002) report identified three fundamental principles of Corporate Governance as openness, integrity and accountability. The report defined these three principles in the context of the private and public sector. On the other hand, the report of the Nolan Committee published in May 1995 identified and defined seven general principles of conduct that should underpin an organization's public life. The committee recommended that all public sector entities should draw up codes of conduct incorporating these principles to guide the operation of the company and behaviour of members. The principles are selflessness, integrity, objectivity, openness, honesty and leadership.

Corporate Governance seeks to find the appropriate mechanisms for governing the relationships of constituent groups within the organization so as to generate long-term value.

It reduces conflict of interest among stakeholders and makes sure that the right people make the decisions. It ensures that corporate power is exercised in the best interest of society. It also helps in the alignment of responsibility and authority to be able to achieve conditions for growth and success (PSCGT, 2002). Effective Corporate Governance ensures that long term strategic objectives and plans are established and the proper management and management structures are in place to achieve those objectives, while at the same time making sure that the structure functions to maintain the company's integrity, reputation and accountability to its relevant constituents. The right system of checks and balances should be the basis of merit for any Corporate Governance system (Ledgerwoods, 1981).

## 2.4 Pillars of Good Corporate Governance

Different authors and management specialists have argued that corporate governance requires laid down procedures, processes, systems and codes of regulation and ethics that ensure its implementation in organizations. Some suggestions that have been underscored in this respect include the need for banks to set strategies – which have been commonly referred to as corporate strategies - for their operations and establish accountability for executing these strategies. El-Kharouf (2000) while examining strategy, corporate governance and the future of the Arab banking industry, points out that corporate strategy is a deliberate search for a plan of action that will develop the corporate competitive advantage and compounds it.

In addition to this, the Basel Committee on Banking and Supervision (1999) contends that transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a bank. The Committee advances further that various corporate governance structures exist in different countries hence there is no universally correct answer to structural issues and that laws do not need to be consistent from one country to another. Sound governance therefore, can be practiced regardless of the form used by a banking organization. The Committee therefore suggests four important forms of oversight that should be included in the organizational structure of any bank in order to ensure the appropriate checks and balances and these include:

1) Oversight by the board of directors or supervisory board;
2) Oversight by individuals not involved in the day-to-day running of the various business areas;
3) Direct line supervision of different business areas, and;
4) Independent risk management and audit functions.

In summary, they demonstrate the importance of key personnel being fit and proper for their jobs and the potentiality of government ownership of a bank to alter the strategies and objectives of the bank as well as the internal structure of governance hence the general principles of sound corporate governance are also beneficial to government-owned banks.

The concept of good governance in banking industry empirically implies total quality management, which includes six performance areas (Khatoon, 2002). These performance areas include capital adequacy, assets quality, management. earnings, liquidity, and sensitivity risk. Khatoon argues that the degree of adherence to these parameters determines the quality rating of an organization.

Corporate governance mechanisms including accounting and auditing standards are designed to monitor managers and improve corporate transparency. (Tsui and Gul, 2000). A number of corporate governance mechanisms have been identified analytically and empirically. These, according to Agrawal and Knoeber, (1996), may be broadly classified as internal and external mechanisms.

## 2.5 Global corporate governance

The World Bank Group and the Organization for Economic Co-operation and Development have established the Global Corporate Governance Forum to build a consensus in favour of appropriate policy, regulatory and corporate reforms, co-ordinate and disseminate corporate governance activities, provide corporate development and human capacity building in the associated fields of corporate governance and train the various professionals and other agents who are essential to bringing about a culture of compliance.

During the October 1997 commonwealth Heads of Government in Edinburgh it was resolved that, capacity should be established in all Commonwealth countries to create or reinforce corporations to promote good corporate governance in particular, codes of good practice establishing standards of behaviour in public and private sector should be agreed to secure greater transparency and to reduce corruption. The Commonwealth Association for Corporate Governance (CACG) was subsequently established and developed the CACG Guidelines- Principles for Corporate Governance in the Commonwealth which were adopted at the November 1999 Commonwealth Heads of Government in Durban, South Africa, as guidelines for all Commonwealth countries to develop or enhance their own national corporate governance principles (The Pan African Consultative Forum on Corporate Governance, 2004).

## 2.6 Corporate Governance in East Africa

Regional conferences were held in Kampala Uganda, in June 1998 and September 1999 to create awareness and promote regional co-operation in matters of corporate governance. At the June 1998 conference, the earlier resolutions were affirmed and recommendations made, to harmonize corporate governance in the East African region under the auspices of the East African Co-operation, through the establishment of regional apex body to promote corporate governance. At the September 1999 Conference, the earlier resolutions were re-affirmed and recommendations made, encouraging the member states to collaborate with other African initiatives in promoting good corporate governance (Dondo, 2000).

Uganda has established the institute of Corporate Governance of Uganda and is formulating a national code of best practice for corporate governance. In Kenya the Private Sector Initiative for corporate Governance continues to liaise with Uganda and Tanzania toward the establishment of a regional centre of excellence in Corporate Governance (Dondo, 2000).

## 2.7 Corporate Governance in Kenya

Consultative Corporate Sector seminars held in November 1998 and March 1999 resolved that Private Sector Initiative for Corporate Governance be formed to formulate and develop a code of best practice for Corporate Governance, to explore ways and means of facilitating the establishment of national apex body the National Corporate Sector Foundation to promote corporate governance, to co-ordinate development in corporate governance in Kenya with other initiatives in East Africa, Africa, the Commonwealth and globally (Central Bank of Kenya, 2001).

In October 8, 1999 the Corporate Sector at a seminar organized by the private Sector Initiative for Corporate Governance formally adopted a national code of best practice governance in Kenya, and mandated the Private Sector Initiative to establish the Corporate Sector Foundation, and collaborate with the global Corporate Governance Forum, the Commonwealth Association for Corporate Governance, the African Capital Markets Forum, Uganda and

Tanzania in promoting good Corporate Governance (Central Bank of Kenya, 2001).

### 2.8 Corporate Governance and the banking Industry in Kenya

Macey and O'Hara (2003) argue that commercial banks pose unique corporate governance problems for managers and regulators, as well as investors and depositors. They observe that the intellectual debate in corporate governance has focused on two very different issues:

- Whether corporate governance should focus exclusively on protecting the interests of equity claimants in the corporation or whether corporate governance should instead expand its focus to deal with problems of other groups – stakeholders – or non-stakeholder constituencies.
- Corporate governance should concern itself exclusively with the challenge of protecting equity claimants and attempts to specify ways in which the corporation can better safeguard those interests.

In addition, they state that the dominant model of corporate governance in law and economics is that the corporation is a "complex set of explicit and implicit contracts" meaning one should view the corporation as nothing than a set of contractual arrangements among the various claimants to the products and earnings generated by the business. The group of claimants include shareholders, but also creditors, employee-managers, the local communities in which the firm operates, suppliers and customers. They contend that in the case of banks, these claimants also include the regulators in their role as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants.

According to Central Bank of Kenya (2002), corporate governance in the banking sector largely relates to the responsibility conferred to and discharged by the various entities and persons responsible for and concerned with the prudent management of the financial sector.

In January 2002 the Capital Markets Authority while responding to the growing importance of corporate governance, issued a Gazette Notice spelling out the guidelines, adherence to which is mandatory to all public listed banks. The Central bank observes that many of the requirements are already taken care of either in the Banking Act or in prudential regulations, but notes further that even though this may be the case, there are some other issues contained in the guideline that the banking sector is yet to adopt and these include

- Disclosure of the ten major shareholders of the company,
- Requirement that no person should hold more than five directorship in any public listed companies at any one time,
- Executive directors to have a fixed service contract not exceeding five years with a provision for renewal,
- No person to hold more than two chairmanships in any public listed company at any one time, and;
- Inclusion of a statement on corporate governance in the annual accounts.

The Central Bank has also gone a step further to request all banks including those that are not quoted to include a statement on corporate governance in their annual accounts. The Central Bank is also committed to encouraging all financial institutions and especially the private ones to adopt the Capital markets Authority guidelines and Commonwealth principles on corporate governance.

**2.9 The conceptual framework**

Looking at agency and contracting at a general level, corporate governance can be described as a problem involving an agent – the CEO of the corporation – and multiple principals – the shareholders, creditors, suppliers, clients, employees, and other parties with whom the CEO engages in business on behalf of the corporation. Boards and external auditors act as intermediaries or representatives of these different constituencies. This view dates back to at least Jensen and Meckling (1976), who describe a firm in abstract terms as "a nexus of contracting relationships". Using more modern language the corporate governance problem can also be described as a "common agency problem", that is an agency problem involving one agent (the CEO) and multiple principals (shareholders, creditors, employees and clients.

Corporate governance rules can be seen as the outcome of the contracting process between the various principals or constituencies and the CEO. Thus, the central issue in corporate governance is to understand what the outcome of this contracting process is likely to be, and how corporate governance deviates in practice from the efficient contracting benchmark.

Standard agency theory of corporate governance, according to Shleifer and Vishny, (1997), focuses on the separation of ownership and control and investigates the mechanisms via which the suppliers of capital influence managerial decisions with varying degrees of success.

Caprio and Levin (2002) develop this further by observing that small shareholders may seek to exert corporate governance by voting directly on major decisions, electing boards of directors, and signing incentive contacts with managers that link pay to performance.

Similarly, debt holders may seek to constrain managerial discretion through covenants, such that default or violation of a covenant typically gives debt holders the right to repossess collateral, initiate bankruptcy proceedings and vote on removing managers.

In their discourse on concepts and international observations on corporate governance of banks Caprio and Levin (2002) have offered a conceptual framework for analyzing corporate governance in banks. In this discourse, they observe that banks are particularly opaque (informational barriers) hence it is very difficult for outsiders to monitor and evaluate bank managers. This opaqueness makes it more difficult for diffuse equity and debt holders to write and enforce effective incentive contracts, to use their voting rights as a vehicle for influencing firm decisions, or to constrain managerial discretion through debt covenants. They argue further that government regulations frequently exacerbate corporate control problems in banks. Deposit insurance virtually eliminates any efforts by small depositors to monitor managers. Given that small depositors are unlikely to play a large corporate governance role even in the absence of deposit insurance, the more destructive effect of deposit insurance is that it reduces the need for banks to raise capital from large, uninsured investors who have the incentives to exert corporate control. More over as Boot and Thakor, (1993) observed, governments themselves are frequently the biggest problem as government regulators and supervisors typically have their own agendas that do not coincide with maximizing bank value. Governments therefore, may directly hurt bank performance and stability by imposing their own preference on bank managers.

According to Caprio and Levine (2002), large informational barriers imply that outside bidders will neither have sufficient information to initiate a take over, nor will outsiders generate a sufficient takeover threat to limit managerial discretion. They argue that regulatory restrictions on entry and takeovers also reduce competition for corporate control in banking.

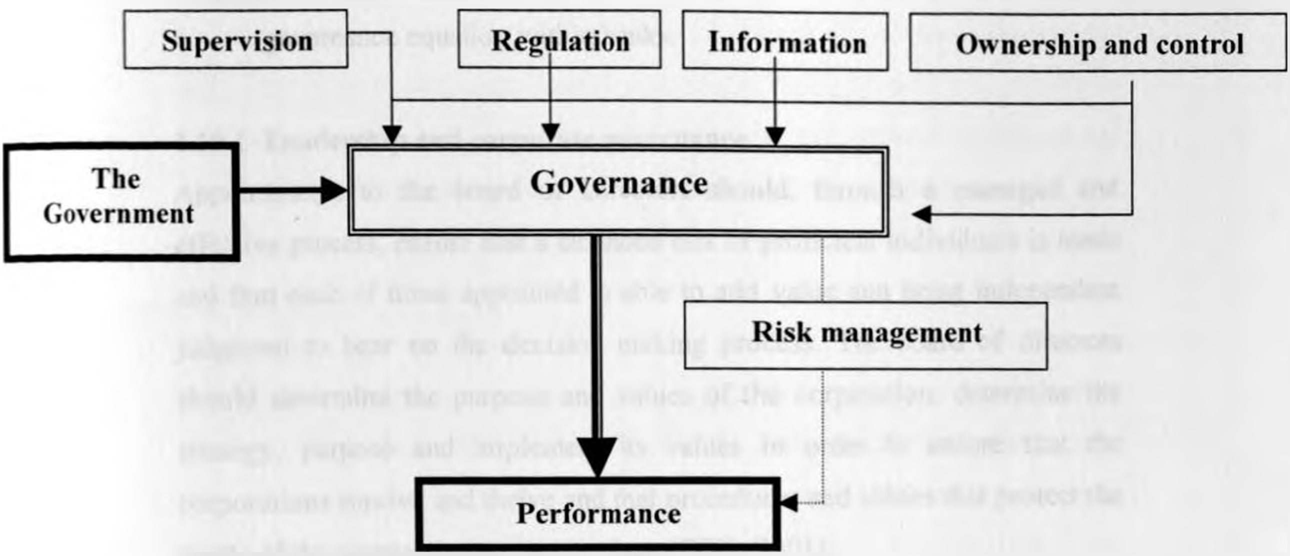
Thus from many angles, they argue, the opaqueness of the banking industry along with pervasive government regulations severely limits effective corporate governance of banks.

In a synopsis, the enhancement of information disclosure system, creation of incentives for private agents to monitor banks, and strengthening legal and bankruptcy systems will fundamentally improve the infrastructure of corporate governance.

In another discourse, Berth *et al* (2001) demonstrate that regulation and supervisory systems that foster more accurate information disclosure, empower private investor's legal rights, and do not offer very generous deposit insurance substantially boost banking system performance and stability. Alchin (1950) and Stigler (1958) stress the importance of competition. On the same view, Berth *et al* (2001) emphasize that competition among banks also does improve corporate governance within them. For example banking systems that permit foreign entry and that allow banks to compete along many dimensions enjoy higher levels of banking development and less banking sector fragility.

From the foregoing discussion the study will adopt the following conceptual framework

**Figure 1: The Conceptual framework**




*Adapted from the governance study report 2004*

Within this framework, it can be argued that:

1. First, governments construct the basic legal system underpinning corporate governance,
2. Second, governments may influence the flow of corporate finance by insuring corporate finance and other intermediaries like providing guarantees for holders of the largest mutual funds.
3. Type of ownership and control, directly have a bearing on the shareholders (minority and concentrated shareholders) on how they exert corporate governance through their votes.
4. Information asymmetry between inside and outside investors create more difficulty for equity and debt holders to monitor managers and use incentive contracts. It makes it easier for managers and large investors to exploit the benefits of control rather than maximize value. It also makes it difficult for potential outside bidders with poor information to generate a sufficiently effective takeover threat to improve governance substantially.

5. Regulations frequently impede natural corporate governance mechanisms.
6. Government ownership of banks fundamentally alters the corporate governance equation within banks.

### 2.10.1 Leadership and corporate governance

Appointments to the board of Directors should, through a managed and effective process, ensure that a balanced mix of proficient individuals is made and that each of those appointed is able to add value and bring independent judgment to bear on the decision making process. The board of directors should determine the purpose and values of the corporation, determine the strategy, purpose and implement its values in order to ensure that the corporations survive and thrive and that procedures and values that protect the assets of the corporation are put in place (CBK, 2001).

The board should monitor and evaluate the implementation of strategies policies and management performance criteria and the plans of the corporation. It should identify the corporation's internal and external stakeholders; agree on a policy or policies determining how the corporation should relate to, and with them, increasing wealth, jobs and sustainability of a financially sound corporation while ensuring that the rights of stakeholders established by law or custom are expected, recognized and protected. The Board should ensure that no one person or group of persons has unfettered power and that there is an appropriate balance of power on the board so that it can exercise objectives and independent judgment (CBK, 2001).

### 2.10.2 Growth and Profitability

The growth in competition among banks in many markets has driven many institutions to better understanding their clients' needs and take a market-led approach to their business. The well-documented high levels of "drop out, exit" or "desertion" in many traditional banking institutions reinforce this tendency. The development of a more client – responsive, market led approach to banking is an important watershed in the industry, (Chavex, 1995).

For most banks responding to the market has meant developing new products that meet the needs of their clients. Experience has shown, however, that product development is the strategic entry point into a broader approach to banking. Developing new products inevitably leads the banks to re-examine and possibly overhaul larger institutional issues. Some banks are beginning to move towards a strategic marketing approach that looks at corporate brand and identity, product delivery systems and customer service strategies, in addition to the product strategy. This broader perspective is known as the market-led approach to banking (Chavex, 1995).

There are many benefits in adopting a market-led approach to micro finance for both the banks and their clients. For the banks, a market-led approach enhances customer loyalty and reduces dropouts and thus increases profitability. More appropriate, client-responsive products allow them to better manage their household finances with a variety of financial services and products, in which they have confidence through systems and people that are secure, efficient and satisfying. Seen at the sectoral level, the market-led approach lies at the heart of making financial markets work for the customers. Commercial viability will increasingly depend on achieving large-scale operational efficiencies and the ability to offer value-added products to clients (Chavex, 1995).

### 2.10.3 Strategic Management

There is need for strategic management of the commercial banks in Kenya to ensure their positive performance. The board of directors should determine the purpose and values of the corporation, determine the strategy its purpose and implement its values in order to ensure that the corporation survives and thrives and that procedures and values that protect the assets of the corporation are put in place, as well as to monitor and evaluate the implementation of strategies policies and management performance criteria and the plans of the corporation. In addition, the board should constantly review the viability and financial sustainability of the enterprise and must do so at least once a year.

The board should also ensure that a proper management structure is put in place and make sure that the structure functions to maintain corporate integrity, reputation and responsibility (Small enterprises foundation, 2000).

### 2.10.4 Risk Factors of Banks.

People, property, earning Capacity (Finance) and reputation are the most important assets. Their preservation and security are essential for continued growth and long-term survival. (Ledgerwood 1998). The approach of risk management involves identification and assessment of the risks to which a business enterprise is exposed.

It is often assumed that on average owners/investors are risk averse. Thus, investors seek to minimize risk for a given level of return. Therefore, one of the main objectives of corporate governance is taken to be the creation of decision structures which prevent the agent from engaging in activities which expose the investor to a higher level of risk than that desired by the shareholders. Therefore, proper governance is deemed to require systems that prevent this problem, such that the agent finds it difficult to take higher risks than desired by owners.

In banks, the framework of action, motivation and behaviour is quite different. Because current banking regulation is concerned first and foremost with the existence of systemic risk, regulation applies to those policy instruments deemed effective in limiting systemic risk. Of those instruments, the lender of last resort and systems of deposit insurance are the ones deemed to be the best means to prevent contagion, bank runs and other threats to system integrity. From a governance perspective, however, the presence of these policy instruments dramatically changes the relationship between the agent and the principal in banks and the conceptual framework required to understand it.

In principle, there appears to be no upper limit to the risk the regulator is willing to bear, the question that arises from a governance perspective is would investors (principals) in banks have an incentive to encourage excessive risk taking by their agents? Banking regulations normally include some attention to risk taking by bank managers.

# SECTION THREE

# 3.0 RESEARCH METHODOLOGY

### 3.1 Research design

The study adopted a descriptive sample survey of all the commercial banks in Kenya. The descriptive survey is useful in locating and obtaining secondary data for the study and describes issues as they are. Gay (1981) defines a survey as "an attempt to collect data from members of a population in order to determine the current status of the population with respect to one or more variables". He says that a descriptive study determines and reports the way things are and commonly involves assessing attitudes, and opinions towards individuals, organizations and procedures.

### 3.2 Study Population

The population of interest was the senior bank managers of all commercial banks in Kenya. All the commercial banks represented in Nairobi were considered including the foreign owned, private and public owned banks. Information from the Central Bank indicates that as at May 2006(July monthly economic bulletin), there were 45 commercial banks in Kenya. (Appendix 1)

### 3.3 Sampling Strategy

This was a sample survey where the researcher adopted the stratified random sampling technique to give all the banks an equal chance but based on the respective strata. Strata were identified from the various classifications of banks by the central banks as shown in appendix 1. By assigning random numbers to the banks in each category, a list of the sample was made upon which the researcher undertook the task.

The respondents were senior bank officers who are fairly knowledgeable on the bank operations

### 3.4 Data Collection

### 3.4.1 Data Collection Instruments

The researcher collected data by the use of questionnaires, which contained both open-ended and close-ended questions.

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i) These were administered to the managers, who were expected to provide information on corporate governance and strategies, as well as providing any other necessary information for the study. The researcher used the drop- and –pick method of administering the questionnaires. The use of questionnaires was preferred for this study because it is the typical method through which descriptive data is collected (Gay 1981).

### 3.4.2 Data Collection Procedures

This involved the following:

i) An introductory letter from the University of Nairobi to the respective institutions introducing the researcher as a student of the same university and outlining the purpose of the research study.

ii) A visit to the commercial banks to organize and book appointments with the Managers.

iii) The actual data collection, by administering the questionnaires to the respondents.

## 3.5 Data and Data Analysis

Data for this study was analyzed using descriptive statistics,mainly tables and graphs, with the application of the Statistical Package for Social Sciences (SPSS) software.

# SECTION FOUR

## 4.0 RESULTS AND FINDINGS

### 4.1 Descriptive Statistics

This section gives a summary of the descriptive statistics relating to the surveyed banks. A total of 25 completed questionnaires were obtained in the study survey. All the surveyed institution considered themselves as commercial banks as licensed under the banking Act.

### 4.1.1 Years of Operation

Table 4.1.1 below gives a summary of the number of years in which the surveyed banks have been in operation.

***Table 4.1.1: Years in Operation***

| *Years* | *Frequency* | *Percent* |
|---|---|---|
| 1 – 10 | 3 | 15.9 |
| 11 - 20 | 7 | 37.1 |
| 21 - 50 | 7 | 37.1 |
| > 50 | 3 | 15.9 |
| Total | 20 | 100 |

The results show that more than 70% of the responding banks have been in operation for more than 10 years. Three banks have been in operation for less than ten years.

### 4.1.2 Range of Services

Table 4.1.2 below gives a summary of the range of services that the surveyed institutions offered their customers.

**Table 4.1.2: Range of Services**

| *Services* | *Category Label* | *Frequency* | *Percentage* |
|---|---|---|---|
| Deposit Mobilization | 1 | 21 | 100.0 |
| Trade Finance | 2 | 21 | 100.0 |
| Small Scale Loans | 3 | 19 | 90.5 |
| Savings and Current Accounts | 4 | 20 | 95.2 |
| Mortgages | 5 | 6 | 28.6 |
| Insurance Premiums | 6 | 2 | 9.5 |
| Custodial services | 7 | 2 | 9.5 |
| Total responses | | 91 | 433.3 |

Table 4.1.2 above shows that all the surveyed banks offer deposit mobilization and trade finance services. More than 90% of the surveyed banks also offer small-scale loans and savings and current accounts. Only two banks (9.5%) offer insurance premiums and custodial services.

### 4.2.0 Management and the Board

This section gives a summary of responses relating to bank management and the involvement of shareholders in management and in guiding the strategy, values and performance of the surveyed banks.

### 4.2.1 Number of Directors

Table 4.2.1 below gives a summary of the numbers of members of the Boards of Directors of the surveyed banks.

***Table 4.2.1: Total number of Board of Directors***

| *Class Interval* | *Frequency* | *Percent* |
|---|---|---|
| 1 – 5 | 6 | 30 |
| 6 – 10 | 13 | 65 |
| > 10 | 1 | 5 |
| Total | 20 | 100 |

The results show that in most banks, the number of members of the board of directors' ranges from 6 – 10 (65%). Only one bank has a board of more than ten members.

### 4.2.2 Methods of Appointing the Board

Table 4.2.2 below gives a summary of the methods used to appoint the boards of directors at the surveyed banks.

**Table 4.2.2: Methods of Appointing the Board**

| *Method* | *Frequency* | *Percent* |
|---|---|---|
| Vote of Majority Shareholders | 9 | 45.0 |
| Vote of all Shareholders | 8 | 40.0 |
| Head hunt by Chairman | 2 | 10.0 |
| Other | 1 | 5.0 |
| Total | 20 | 100.0 |

Table 4.2.2 above shows that in most instances (45%), the board of directors is appointed by vote of the majority shareholders. In one case, the directors were appointed by delegates of co-operative saccos that owned the bank.

### 4.2.3 Board Composition by Profession

Table 4.2.3 below gives a summary of the professional qualifications of the board members of the surveyed banks.

**Table 4.2.3 Composition of Board by Profession**

| *Profession* | *Frequency* | *Percent* |
|---|---|---|
| Lawyers | 11 | 44 |
| Banking and Finance Specialists | 18 | 72 |
| Certified Public Accountants | 12 | 48 |
| Engineers | 6 | 24 |
| Economists | 8 | 32 |

The above results show that 72% of the surveyed banks have banking and finance specialists as members of their board of directors. Six banks (24%) also include engineers amongst their board of directors.

### 4.2.4 Board Effectiveness

Respondents were asked to rate the effectiveness of their board of directors in leadership, integrity, enterprise, judgment and decision-making. The rating scale had four levels: [1] very effective, [2] not very effective, [3] effective, and [4] below average. The results are summarized in figure 1 below.

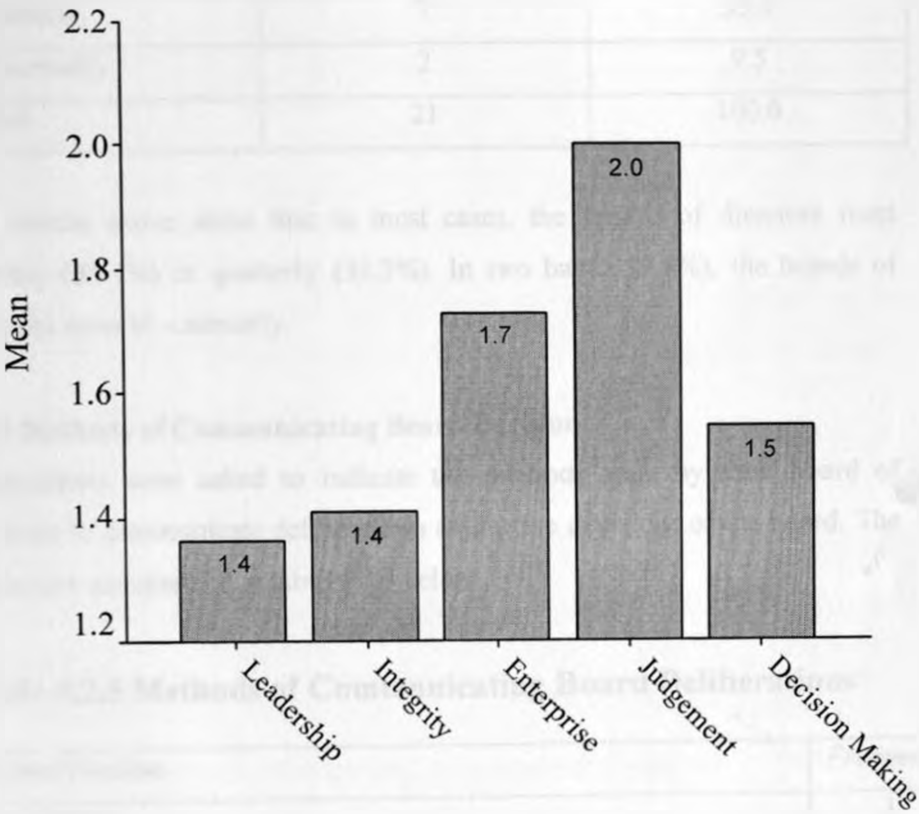


**Figure 1: Board Effectiveness Rating**

The above results show that respondents considered their boards of directors most effective in integrity and leadership [mean rating 1.4] and not very effective in judgment [mean rating 2.0].

#### 4.2.4 Frequency of Board Meetings

Table 4.2.4 below gives a summary of the frequency of board meeting of the surveyed banks.

### *Table 4.2.4: Frequency of Board Meetings*

| *Frequency of Meetings* | *Frequency* | *Percent* |
|---|---|---|
| Monthly | 8 | 38.1 |
| Bi-weekly | 4 | 19.0 |
| Quarterly | 7 | 33.3 |
| Bi-annually | 2 | 9.5 |
| Total | 21 | 100.0 |

The results above show that in most cases, the boards of directors meet monthly (38.1%) or quarterly (33.3%). In two banks (9.5%), the boards of directors meet bi – annually.

#### 4.2.5 Methods of Communicating Board Decisions

Respondents were asked to indicate the methods used by their board of directors to communicate deliberations and/or the decisions of the board. The results are summarized in table 4.2.5 below.

### Table 4.2.5 Methods of Communicating Board Deliberations

| *Method/Medium* | *Frequency* | *Percent* |
|---|---|---|
| Newsletters | 3 | 15.0 |
| Press | 7 | 35.0 |
| Posted letters | 4 | 20.0 |
| Board meetings [< 10 Shareholders who are also board members] | 1 | 5.0 |
| Management Memos and Circulars | 5 | 25.0 |
| Total | 20 | 100.0 |

The results show that in most cases, the decisions of the board are communicated through press adverts/announcements. In one case, the decisions are communicated at board meetings.

### 4.2.6 Board Performance Effectiveness Appraisal

Table 4.2.6 below summarizes responses to whether the board assess performance and effectiveness of itself, individual members and the chief executive.

### Table 4.2.6: Performance Appraisal

| *Performance appraisal* | *Response* | *Frequency* | *Percentage* |
|---|---|---|---|
| Board | Yes | 13 | 52 |
| Individual Board Members | Yes | 16 | 64 |
| Chief Executive | Yes | 25 | 100 |

The results show that the board appraises the performance of chief executive in all cases and of individual board members in 64% of cases. In thirteen cases, the board also appraises its own performance.

### 4.2.7 Assessment Reports

Nineteen banks (76%) make reports after a performance and evaluation exercise. Table 4.2.7 below gives the levels at which such reports are discussed.

### Table 4.2.7 Level of Discussing Assessment Reports

| *Level* | *Frequency* | *Percent* |
|---|---|---|
| Board Meeting | 14 | 58.3 |
| Annual General Meetings | 4 | 16.7 |
| Special Meetings | 6 | 25.0 |
| Total | 24 | 100.0 |

The results show that in 58% of cases, performance appraisal reports are discussed in board meetings. Six banks (25%) use special meetings to discuss such reports.

### 4.2.8 Management Training

Table 4.2.8 below summarizes banks management training and induction programmes.

| *Training Programme* | *Frequency* | *Percent* |
|---|---|---|
| Induction for New Board Members | 14 | 56 |
| Continuous member skills development | 13 | 52 |
| Management training programmes | 21 | 84 |

The results show that 84% of the surveyed banks have management-training programmes. Thirteen banks have continuous board members skill development programmes.

### 4.2.9 Succession Planning

Eighteen banks (72%) have management succession plans. Table 4.2.9 below gives a summary of the type of plans at different banks.

***Table 4.2.9: Succession Plan***

| *Type of Plan* | *Frequency* | *Percent* |
|---|---|---|
| Graduate Trainee Program | 2 | 8.3 |
| Management Trainee Program | 11 | 75.0 |
| Succession Planning Program | 4 | 16.7 |
| Total | 18 | 100.0 |

The results show that in most cases, the succession plan is hinged on the management-training program.

### 4.3 Shareholders and Stakeholders

This section summarizes responses on the relationships between the shareholders and the board of directors. The numbers of individual shareholders range from a minimum of two to a maximum of 57,000. Institutional shareholders range form one to nine. Respondents indicated that potential board members were seriously screened before appointment. In most cases, respondents indicated that the board was 100% accountable to the shareholders. In 14 banks, shareholders also had the power to change the composition of the board of directors.

### 4.3.1 Procedures for Ensuring Accountability

Respondents were asked to indicate the procedures that were in place to ensure accountability to shareholders. The results are summarized in table 4.3.1 below.

**Table 4.3.1 Accountability Procedures**

| *Procedure* | *Frequency* | *Percent* |
|---|---|---|
| Monitoring | 8 | 32.0 |
| Regular reporting | 2 | 8.0 |
| Internal Auditing and Controls | 6 | 24.0 |
| None | 9 | 36.0 |
| Total | 25 | 100.0 |

In most cases (36%), banks didn't have such procedures. Other banks used monitoring (32%), internal auditing and controls (24%) and regular reporting (8%). Nineteen respondents further indicated that they believed shareholders were either satisfied or very satisfied with these procedures.

### 4.3.2 Stakeholders

Table 4.3.2 below summarizes the internal and external stakeholders of the surveyed banks.

**Table 4.3.2 Internal and External Stakeholders**

| *Internal Stakeholders* | *Frequency* | *Percent* |
|---|---|---|
| Staff | 10 | 40.0 |
| Staff and suppliers | 2 | 8.0 |
| Staff, customers and other contracted parties | 4 | 16.0 |
| *External Stakeholders* | | |
| Community | 6 | 24.0 |

| | | |
|---|---|---|
| Government and community | 9 | 36.0 |
| Customers and suppliers | 6 | 24.0 |

Ten banks (40%) consider the internal stakeholders to be their staff members. Nine banks (36%) also consider the government and the community to be their external stakeholders. Nineteen banks (79%) further indicate that they have policies to deal with both stakeholder groups.

### 4.4 Strategies, Values, Performance and Compliance

#### 4.4.1 Role Board of Directors

Respondents were asked to indicate the level of involvement of the board of directors in determining the purpose of the bank, the strategy to achieve the banks values and the implementation of the banks values. Respondents rated their board's involvement on the following three point scale: [1] in all cases, [2] sometimes, [3] not at all. The results are summarised in figure 2 below.

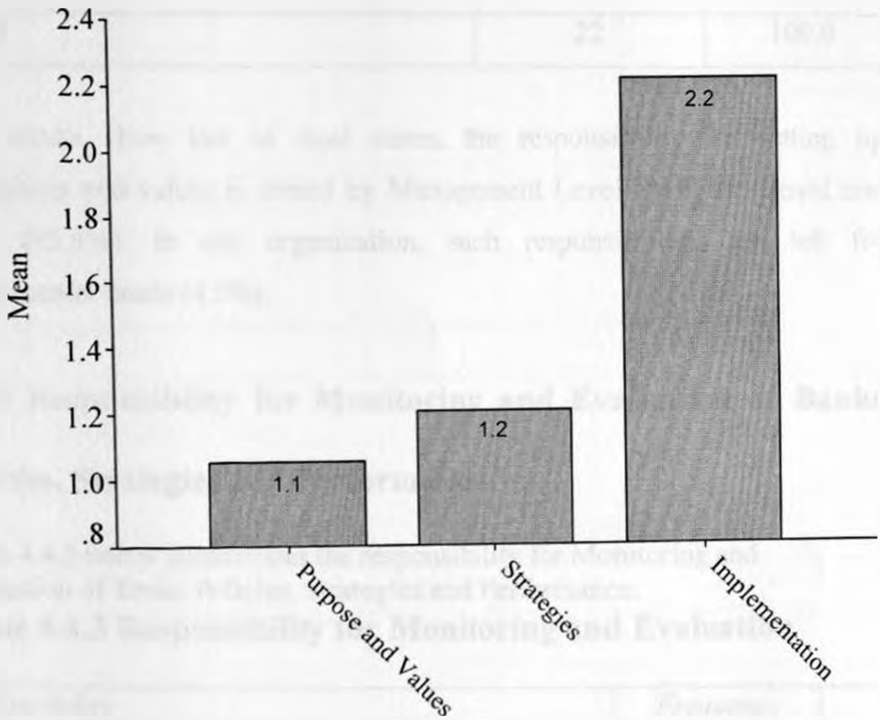


**Figure 2: Boards involvement in Strategies, Values and their Implementation**

The above results show that the board is involved in determining purpose and values, and strategies in all cases [mean rating < 1.2] and is sometimes involved in implementation [mean rating 2.2].

### 4.4.2 Responsibility for Setting up Bank Procedures and Values

Table 4.4.2 below summarizes the responsibility of creating procedures and values

**Table 4.4.2 Responsibility for Setting up Procedures and Values**

| *Responsibility* | *Frequency* | *Percent* |
|---|---|---|
| The Board | 3 | 13.6 |
| Chief Executive Officer | 4 | 18.2 |
| Departmental Heads | 1 | 4.5 |
| Management Level Staff, the Board and CEO | 14 | 63.6 |
| Total | 22 | 100.0 |

The results show that in most cases, the responsibility for setting up procedures and values is shared by Management Level Staff, the Board and CEO (63.6%). In one organization, such responsibilities are left for departmental heads (4.5%).

### 4.4.3 Responsibility for Monitoring and Evaluation of Banks Policies, Strategies and Performance

Table 4.4.3 below summarizes the responsibility for Monitoring and Evaluation of Banks Policies, Strategies and Performance.

**Table 4.4.3 Responsibility for Monitoring and Evaluation**

| *Responsibility* | *Frequency* | *Percent* |
|---|---|---|
| The Board | 7 | 31.8 |
| Chief Executive Officer | 7 | 31.8 |
| Management Level Staff, the Board and CEO | 8 | 36.4 |
| Total | 22 | 100.0 |

The results show that in most cases, monitoring and evaluation is shared between Management Level Staff, the Board and CEO (36.4%). The Board or the CEO may also shoulder the responsibility, both in 31.8% of cases.

### 4.4.4 Responsibility for Review of Bank Viability and Financial Sustainability

Table 4.4.4 below summarizes the responsibility for bank viability and sustainability.

***Table 4.4.4 Responsibility for Viability and Sustainability***

| *Responsibility* | *Frequency* | *Percent* |
|---|---|---|
| The Board | 16 | 72.7 |
| Shareholders | 4 | 18.2 |
| Management Level Staff, the Board and CEO | 2 | 9.1 |
| Total | 22 | 100.0 |

The results show that viability and sustainability is mostly a responsibility of the board (72.1%). In two cases, management level staff, the board and CEO shares this responsibility.

### 4.4.5 Frequency of Viability and Sustainability Reviews

Table 4.4.5 below summarizes the frequency of reviews to check the bank's viability and sustainability.

**Table 4.4.5: Frequency of Viability and Sustainability Reviews**

| *Period* | *Frequency* | *Percent* |
|---|---|---|
| Yearly | 8 | 38.1 |
| Half Yearly | 2 | 9.5 |
| Quarterly | 11 | 52.4 |
| Total | 21 | 100.0 |

The results show that in most cases, the reviews are performed quarterly.

### 4.4.6 Compliance with Laws, Regulations and Standards

Twenty-two banks (88%) have Measures to Ensure Compliance with Laws, Regulations, Governance Practices, Accounting and Auditing Standards. Respondents were asked to list at least three such measures that their banks were using. The results are summarized below.

**Table 4.4.6: Measures to Ensure Compliance with Laws, Regulations and Practices**

| *Measures* | *Frequency* | *Percent* |
|---|---|---|
| Membership of Professional Bodies | 10 | 50.0 |
| Transparency Index Listings | 4 | 20.0 |
| Subscribing to certain pieces of legislation | 6 | 30.0 |
| Risk based policies | 4 | 20.0 |
| Inviting external auditors and CBK Audit | 11 | 55.0 |
| Internal compliance department | 7 | 35.0 |

Eleven banks (55%) invite external and CBK auditors as a measure to ensure compliance with laws, regulations and other practices.

## 4.5 Management of Corporate Risk and Social Responsibility

This section gives a summary of the key risk areas that have been identified by the board, key performance indicators and circumstances under which banks have sought the help of consultants.

### 4.5.1 Risk Areas

Table 4.5.1 below summarises the risk areas that have been identified by the boards of directors of the surveyed banks.

**Table 4.5.1: Key Risk Areas Identified**

| *Risk* | *Code* | *Frequency* | *Percent* |
|---|---|---|---|
| Terrorism | 1 | 3 | 16.7 |
| Money Laundering | 2 | 7 | 38.9 |
| Lending to certain sectors of the economy | 3 | 10 | 55.6 |
| Operational Interest rate risks | 4 | 7 | 38.9 |

The above results show that the most considered risk is that of lending to certain sectors of the economy.

### 4.5.2 Key Performance Indicators

Table 4.5.2 summarises the key performance indicators the surveyed banks have in place.

**Table 4.5.2: Key Performance Indicators**

| Indicator | Frequency | Percent |
|---|---|---|
| Regulatory framework based on Money Laundering | 3 | 18.8 |
| Profitability | 11 | 68.8 |
| Staff performance appraisal results | 2 | 12.5 |
| Total | 16 | 100.0 |

**The key performance indicators of the surveyed banks are profitability (68.8%).**

### 4.5.3 Circumstances where Bank Used Consultants

Table 4.5.3 below gives a summary of the circumstances under which the surveyed banks have used outside consultants.

**Table 4.5.3 Circumstances where Banks Uses Consultants**

| *Case* | *Frequency* | *Percent* |
|---|---|---|
| Network Expansion | 1 | 7.7 |
| Re – branding | 2 | 15.4 |
| Taxation | 6 | 46.2 |
| Finding strategic partners | 2 | 15.4 |
| Employee Opinion Survey | 1 | 7.7 |
| In cases of a crisis in sector to which the bank lends | 1 | 7.7 |
| Total | 13 | 100.0 |

The results show that most banks use external consultants to handle matters related to taxation. Banks also used consultants for network expansion, to conduct employee opinion surveys and in cases where there was a crisis in a sector to which the bank had excessively lent.

# SECTION FIVE

## 5.0 SUMMARY, DISCUSSION AND CONCLUSIONS

### 5.1 Conclusion

The study's main objectives were to assess the nature of and characteristics of corporate governance systems of commercial banks in Kenya and to assess the prevalence and extent of use of selected corporate governance practices in the banks. To achieve these objectives, a census survey of all commercial banks operating in the country was carried out. A total of 25 questionnaires were obtained form the survey out of the targeted 45 banks, representing a 56.8% response rate.

The major findings of the study are that the central system for corporate governance responsibility in banks lies with the board of directors. Therefore the manner of appointment to the board, the board composition and the board committees play a vital role in the corporate governance of banks. This compares well with the Basel Committee, which recognizes that the primary responsibility for good corporate governance rests with the board of directors and senior management of banks.

This survey found that the boards in Kenyan banks pursue sound corporate governance practices and in this regard have the following responsibilities:

- Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
- Selecting, compensating, monitoring and, where necessary, replacing key executives and succession planning.
- Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit,

and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.

- Overseeing the process of disclosure and communications.

The boards of directors are involved in determining purpose and values, and strategies of their banks in all cases [mean rating < 1.2] and are sometimes involved in implementation [mean rating 2.2]. Management level staff, the Board and CEO in 63.6% of the surveyed institutions, shares the responsibility of creating procedures and values. In one organization, such responsibilities are left for departmental heads (4.5%). The responsibility for monitoring and evaluation of bank's policies, strategies and performance is shared between Management Level Staff, the Board and CEO (36.4%). In 72% of cases, bank viability and sustainability is the responsibility of the board. In two cases, management level staff, the board and CEO shared this responsibility. In most cases, banks undertake viability and sustainability reviews quarterly.

The Basel Committee on Banking Supervision (1999) considers corporate governance in the banking industry perspective to include how banks set their objectives, run day to day operations, consider the interest of recognized stakeholders and align corporate activities and behaviour with the expectations of safe and sound operations as well as protect the interests of depositors. The results of the survey, which indicate that the boards of directors are involved in setting the values and objective of the bank, are in line with the suggestions of the Basel Committee. The finding that the responsibility for creating procedures and values is shared between the board, the CEO and senior managers is however contrary to Crespi et. al., (2002) contention that corporate governance of banks refers to the methods that owners use to induce management to implement value adding strategies.

Given the above results its concluded that corporate governance within Kenya's commercial banks involves the board of directors setting up the strategies, values and procedures of a bank and ensuring that there is some form of measures to guide the implementation of such strategies and also to ensure that the bank complies with laws, regulations and generally accepted governance practices.

It is also concluded that there is moderate use/prevalence of corporate governance practices within the banking sector in Kenya. The practices most commonly embraced emanate from the following:

- Banks own self-regulatory mechanisms,
- Banking Act requirements,
- Prudential guidelines from the Central Bank,
- Requirements by the Capital markets Authority
- Membership to professional bodies

From this survey it can be concluded that there is a general awareness on the importance of corporate governance in banks and that there have been great advances in this financial sector in complying with the basic corporate governance framework.

As outlined earlier in this paper the banks present a special problem of corporate governance because of their role in the economy and also the nature and diversity of the stakeholders especially the creditors and the depositors. While the responsibility of corporate governance rests with the board of management it is not evident that all the diverse stakeholders are represented in these boards.

**5.2 Recommendations**

An import policy implication is that to bridge the gap that may exist on board representation, there is need for sound regulatory governance. The quality of bank supervision and prudential guidelines needs to be carefully crafted. This sound regulatory governance, which encompasses the governance practices of institutions that have an oversight role in the financial system and not entirely on central bank alone, should be formulated implemented and enforced. To date central bank bemoans that not all their prudential guidelines have been applied or adhered to in their entirety.

### 5.3 Limitations of the study

1. There was presence of gaps in the data collected. The research intended to cover all the banks in the industry but attained 50% of the population. This was largely attributed to the problem of confidentiality where some banks were reluctant to give out information.

2. There was time constraint. Given adequate time the research would also focus on the relationship between bank performance and corporate governance practices

### 5.4 Areas of further research

While the responsibility for the governance lies with board of management, more often, the board relies on information from the banks senior management in their decision-making. The area of further research would be to focus on the role of senior management and its relationship with the board of directors. Since board composition is plays a central role in governance there is need to research on what determines this composition in the banking industry. Another possible area of research is bank performance and application of corporate governance practices.

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## APPENDIX I

## LIST OF BANKS IN KENYA

Institutions in Terms of Shareholding

a). Foreign owned institutions

i). Foreign owned not locally incorporated

1. Citibank N.A.
2. Credit Agricole Indosuez
3. Habib Bank A.G. Zurich
4. Bank of India
5. Habib Bank
6. Bank of India Finance

ii). Foreign owned but locally incorporated institutions (Partly owned by locals)

1. Barclays Bank of Kenya Ltd.
2. Standard Chartered bank Limited
3. Development Bank of Kenya Ltd.
4. Stanbic Bank Ltd.
5. Bank of Baroda Ltd.
6. Diamond Trust Bank Kenya Ltd.
7. K-Rep Bank Ltd.

b). Institutions with Government participation

1. Kenya Commercial Bank Ltd.
2. Housing Finance Company of Kenya Ltd.
3. Stanbic Bank Ltd.
4. Savings & Loan Kenya Ltd.
5. Industrial Development Bank Ltd.
6. National Bank of Kenya Ltd.
7. Consolidated Bank of Kenya Ltd.

c). Institutions locally owned

1. CFC Bank Ltd.
2. Commercial Bank of Africa Ltd.
3. Transnational Bank Ltd.
4. Credit Bank Ltd.
5. Euro Bank Ltd.
6. Daima Bank Ltd.
7. Guardian Bank Ltd.
8. First American Bank Ltd.
9. Investment & Mortgages Bank Ltd.
10. Middle East Bank (K) Ltd.
11. Akiba Bank Ltd.
12. FINA Bank Ltd.
13. Imperial Commercial Bank Ltd.
14. Victoria Commercial Bank Ltd.
15. Prime Bank Ltd.
16. Equatorial Commercial Bank Ltd.
17. Prime Capital & Credit Finance Ltd.
18. Giro Commercial Bank Ltd.
19. Biashara Bank Ltd.
20. African Banking Corporation Ltd.
21. Chase Bank Ltd.
22. City Finance Bank Ltd.
23. Charterhouse Bank Ltd.
24. Paramount Universal Bank Ltd.
25. Southern Credit Banking Corp. Ltd.
26. Fidelity Commercial Bank Ltd.
27. Delphis Bank Ltd. (Under CBK Statutory Mgt.)
28. Devna Finance Ltd.
29. Co-operative Bank of Kenya Ltd.
30. Cooperative Merchant Bank Ltd.
31. National Industrial Credit Bank Ltd.
32. East African Building Society
33. Equity Building Society

34. Family Finance Building Society
35. Prudential Building Society

II. Institutions Listed on the NSE

1. Barclays Bank of Kenya Ltd.
2. Kenya Commercial Bank Ltd.
3. Standard Chartered Bank (K) Ltd.
4. National Industrial Credit Ltd.
5. CFC Bank Ltd.
6. Housing Finance Company of Kenya Ltd.

**Source: Central bank of Kenya 2006**

*APPENDIX II*

# *LETTER*

Mugambi Linyiru
P.O Box 4514-0506
NAIROBI.

Dear Respondent,

**REQUEST TO FILL THE QUESTIONNAIRE FOR RESEARCH PURPOSE**

This is to request you to kindly fill in the attached questionnaire for research purpose. The research focuses on the corporate governance practices of commercial banks in Kenya. The information sought from you will be treated with utmost confidence, and results of this study will be available for your use/reference.

Thank you,

Yours sincerely,

**Mugambi Linyiru**

## APPENDIX III

# QUESTIONNAIRE

# A SURVEY OF CORPORATE GOVERNANCE PRACTICES OF COMMERCIAL BANKS IN KENYA

Date: _______________

Name of Bank: ____________________

## A: Introduction

A1. For how long has this bank been in operation in Kenya? [______Years]

A2. Is this bank: [1] entirely privately owned
[2] owned partly with the government

A3. How would you classify this bank?
[1] commercial bank
[2] non-bank financial institution [other than mortgage or building]
[3] mortgage finance company
[4] building society

A5. What is the range of services that the banks offers? ______________________________
________________________________________________________________________
________________________________________________________________________

## B: Management and the Board

B1. What is the total number of the Board of Directors [______]

B2. How is the board appointed?
[1] by the vote of majority shareholders
[2] by the vote of all shareholders
[3] by the old board when a new one is coming into office
[4] a head hunt by the chairman
[5] other process [please describe] ------------------------------------------------------------

B3. What is the composition of the board in terms of professional qualification?
[1] lawyers [give number__________]
[2] banking and finance specialists [________]
[3] CPA [_______]
[4] engineers [_______]
[5] Economists [_______]
[6] Other professions [list and give numbers] ----------------------------------------------

B4. What is the composition of the board of directors in terms of gender?

[1] male
[2] female
[Give numbers]

B5. How effective do you consider the Board to be in exercising the following so as to achieve the banks objectives:

[1] very effective [2] not very effective [3] effective [4] below average

i. Leadership [____]
ii. Integrity [____]
iii. Enterprise [____]
iv. Judgment [____]
v. Decision making [____]

B6. How frequently does the Board meet? ________________________________

B7. How are deliberations/decisions of the board communicated to shareholders and other stakeholders?

________________________________________________

________________________________________________

B8. Does the board assess the performance and effectiveness of:

1. itself? [1. yes 2. no]
2. individuals members? [1. yes 2. no]
3. the Chief Executive? [1. yes 2. no]

B9. If Yes how frequently is this done?

1. for itself ____________________
2. for individuals members ____________________
3. for the Chief Executive ____________________

B10. Are reports made from these assessments?

[1] yes
[2] no

B11. At what level are the reports discussed?

[1] board meeting
[2] AGM
[3] special meetings
[4] other [indicate] ________________________________

B12. Are there any induction programmes in place for new Board members?

[1] yes
[2] no

B13. Are there continuous members' skill development programmes for the Board?

[1] yes
[2] no

B14. Is there any training programme for the management and other staff?

[1] yes
[2] no

B15. Does the bank have a succession plan for the senior management?

[1] yes

[2] no

16. If yes, briefly explain how it works ____________________

## C: Shareholders and stakeholders

C1. What is the total number of shareholders?
Individual [__________]
Institutional [__________]

C2. To what extent do the shareholders exercise the authority to ensure that only competent and reliable persons are elected or appointed to the Board of Directors? ____________________

What mechanisms are in place to ensure accountability?

C3. To what extent do the shareholders ensure that the Board is held accountable for the effective running of the bank – so as to achieve its objectives? ____________________

C4. Do the shareholders have the power to change the composition of the Board that does not perform to expectations or in accordance with the mandate of the bank?
[1] yes
[2] no

C5. How does the bank communicate with its shareholders and stakeholders? ____________________

C6. To what extent is the bank accountable to its shareholders? ____________________

C7. What accounting procedures are there in place to effect this? ____________________

C8. Do you think the members are satisfied with this?
[1] very satisfied
[2] satisfied
[3] not satisfied at all

C9. Who are the internal stakeholders of the bank? ______________________________

C10.Who are the external stakeholders of the bank? ______________________________

C11. Is there a policy that guides how the bank should relate with them?

[1] yes
[2] no

## D: Strategy, values performance and compliance

D1. Would you say the Board of Directors do determine the following:

( [1] in all cases [2] sometimes [3] not at all )

i. The purpose and values of the bank [___]
ii. The strategy to achieve the bank's purpose [___]
iii. Implementation of the banks values [___]

D2. Who ensures that the procedures and values that protect the assets and reputation of the bank are put in place?

[1] the board
[2] the chief executive
[3] the share holders
[4] all departmental heads
[5] everybody in the management position including the board and the CEO
[6] other [specify]: ______________________________

D4. Who monitors and evaluates the implementation of the bank's strategies, policies, plans and management performance?

[1] the board
[2] the chief executive
[3] the share holders
[4] all departmental heads
[5] everybody in the management position including the board and the CEO
[6] other [specify]: ______________________________

D5. Who reviews the viability and financial sustainability of the bank?

[1] the board
[2] the chief executive
[3] the share holders
[4] all departmental heads
[5] everybody in the management position including the board and the CEO
[6] other [specify]: ______________________________

D6. How frequently is this done? ______________________________

D7. Is there any measure in place to ensure that the bank complies with all relevant laws, regulations, governance practices, accounting and auditing standards?

[1] Yes
[2] No

D8 If yes, please list at least three such measures

_______________________________________________
_______________________________________________
_______________________________________________

QD9. Who enforces these measures?
[1] the board
[2] the chief executive
[3] the share holders
[4] all departmental heads
[5] everybody in the management position including the board and the CEO

## E: Management of corporate risk and social responsibility

E1. What are some of the key risk areas that the board has so far identified? _______________
_______________________________________________
_______________________________________________

E2. What are some of the key performance indicators that the bank has in place? _______________
_______________________________________________
_______________________________________________

E3. In what circumstances has the bank sought the advice of outside consultants?
_______________________________________________
_______________________________________________
_______________________________________________

E4. What are some of the bank's social responsibilities? _______________
_______________________________________________
_______________________________________________

**Thank you for your time**