# RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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# Relationship between Corporate Governance and Performance of Commercial Banks in Kenya

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## DECLARATION

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

Signature …… Date ……

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This thesis has been submitted for examination with our approval as the University supervisors.

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## DEDICATION

To my wife, my son and my daughters, who have been sources of inspiration in my studies.

To all those who made this thesis a success in one way or the other.

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## TABLE OF CONTENTS

## LIST OF TABLES

## LIST OF FIGURES

## LIST OF APPENDICES

## ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| **ANOVA** | Analysis of Variance |
| **CAR** | Capital Adequacy Ratio |
| **CBK** | Central Bank of Kenya |
| **CEO** | Chief Executive Officer |
| **DEA** | Data Envelopment Analysis |
| **EC** | European Community |
| **EPS** | Earning Per Share |
| **JKUAT** | Jomo Kenyatta University of Agriculture and Technology |
| **NPA** | Non Performing Accounts |
| **NSE** | Nairobi Securities Exchange |
| **OECD** | Organization for Economic Cooperation and Development |
| **OLS** | Ordinary Least Square |
| **P/E** | Price to Earnings Ratio |
| **PhD** | Doctor of Philosophy |
| **PM** | Profit Margin |
| **R&D** | Research and Development |
| **RAROC** | Risk Adjusted Return on Capital |
| **ROA** | Return on Asset |
| **ROC** | Return on Capital Employed |
| **ROE** | Return on Equity |
| **Std** | Standard |
| **UoN** | University of Nairobi |
| **UK** | United Kingdom. |
| **USA** | United States of America |
| **VIF** | Variance Inflation Factor |

## DEFINITION OF TERMS

| | |
|---|---|
| **Agency theory** | A theory that explains the relationship between principal and agent arising from the separation of ownership from control of a firm (Uwuigbe, 2012). |
| **Board independence** | The number of non-executive directors to total number of directors in a company (Uwuigbe, 2012). |
| **Board size** | The total number of directors in a firm (Ibrahim *et al.* 2010). |
| **Block ownership** | Computed as the total firm's outstanding shares owned by block holders, which is defined as the sum of the three largest stakes in the bank's equity .(Stepanova & Ivantsova, 2012). |
| **Corporate Governance** | Ways in which suppliers of finance to a firm assure themselves of a fair return on their investment (Shleifer & Vishny, 1997). |
| **Dependent variable** | A variable being affected or assumed to be affected by an independent variable (Maina, 2012). |
| **Independent Variable** | A variable that affects the dependent variable under study (Maina, 2012). |

| | |
|---|---|
| **Institutional ownership** | The fraction of a firm's shares that are held by institutional investors. That one minus the fraction of the company's shares held by non- institutions that is individual investors (Kee & Hao, 2011). |
| **Control variable** | A variable that may or may not be controlled, but has an effect on research situation (Maina, 2012). |
| **Return on asset** | A measurement used to show the ability of the company to utilize assets in an efficient way to generate profits (Mohamad, *et al.* 2011). |
| **Return on equity** | The rate of return on ownership interest (shareholders of equity) of the common stock owners (Vintila & Gherghina, 2012). |
| **Tobin's q** | The ratio between the market value and replacement value of the same physical assets (Vintila & Gherghina, 2012). |

## ABSTRACT

Global events concerning poor performance and eventual collapse of high profile companies have awakened need to strengthen corporate governance in both developed and developing countries. Corporate governance issues have attracted public interest in the banking sector both locally and internationally after waves of corporate rip-offs and failures that almost led to loss of confidence in this important sector. Owing to this, Central bank of Kenya issued the first prudential guidelines on corporate governance for banking institutions in the year 2000 that came in force in 2001.These were superseded by the 2006 and 2013 guidelines respectively. To achieve the general objective of the study, a survey was conducted on 43 commercial banks that were operational. The researcher made use of return on assets, return on equity and Tobin's q ratio as key variables that defined banks performance; whereas bank size was adopted as a control variable. Corporate governance mechanisms were measured using selected internal corporate monitoring mechanisms and ownership monitoring mechanisms. Data on general information and corporate governance mechanisms was collected using a questionnaire. Whereas, data on banks performance, internal corporate monitoring mechanisms, ownership monitoring mechanisms and bank size were collected from secondary sources. Data analysis was primarily done using descriptive and inferential statistics. Under descriptive statistics; mean, maximum, minimum and standard deviations were used and under inferential statistics: partial correlation analysis and hierarchical multiple regression analysis within the panel data framework were used. The findings of the study indicated that board independence was not significant in the relationship between corporate governance and performance of commercial banks when all the three performance measures were used (ROA, ROE and TBQ ratio). Board size was found to have a negative and significant relationship with ROE, a positive and significant relationship with TBQ ratio and no significant relationship with ROA. Under

ownership monitoring mechanisms, institutional and block ownership were found to have a negative and significant relationship with ROE. However they were not found to have any significant effect when TBQ ratio was adopted as a performance measure. It was further revealed that bank size had a positive and significant effect in the relationship between corporate governance and performance of commercial banks when all the three performance measures were used. The findings further indicated that of the three performance measures: ROA, ROE and TBQ ratio, ROE was the best measure of performance in studies of corporate governance mechanisms as they relate to performance in the Kenyan banking sector. From these findings, some policy implications are suggested as follows: commercial banks in Kenya should desist from higher levels of block ownership in order to improve their performance, the regulator should have a seat in the boards of commercial banks so as to improve their effectiveness, the board size of commercial banks in Kenya should be pegged on the bank's capital tier and institutional shareholders should engage in business with commercial banks in which they own shares at an arm's length with close supervision of the regulator.

# CHAPTER ONE
# INTRODUCTION

## 1.1 Background of the Study

The impact of corporate governance on firm performance has received enormous attention in economic and finance literature in recent years. This attention has been motivated by financial scandals that rocked the U.S. economy in early and late 2000 and the Asian financial crisis of late 90s. Despite a number of studies having been undertaken on the subject matter, there is still much debate on the relationship between corporate governance and firm performance and more so on the relationship between corporate governance and performance of commercial banks.

In recognition of the vital role the banking sector plays in economic development, there has been an upsurge of initiatives by Central Banks and Reserve Banks alongside other institutions worldwide such as the Basel Committee on Banking and Supervision and OECD to provide governance principles with a view of enhancing management and performance of this important sector. Most of these initiatives have prominently featured in developed nations such as: U.S.A., United Kingdom, Germany, Canada, and France among others with South Africa taking a lead in addressing corporate governance issues among developing nations (Elewechi, 2007).

The wave of mergers, acquisitions and collapse of banks witnessed in Kenya and other parts of the world came as a wakeup call to the Central Bank of Kenya to strengthen its bank supervision arm (CBK, 2001). In order to achieve this, Central Bank of Kenya has on different occasions issued prudential guidelines on corporate governance that all institutions licensed under the Banking Act Cap 488 laws of Kenya are supposed to adhere to. This move is in line with the findings of Heidi and Maleen, (2003) that banking supervision cannot function well if sound corporate governance is absent.

Chandra (2008), contends that financial analysis, planning and control as a key financial management activity in the firm is concerned with: assessing the financial performance and conditions of the firm, forecasting and planning the financial future of the firm, estimating the financial needs of the firm and instituting appropriate systems of control to ensure that the action of managers are congruent with the goals of the firm. Arnold (2005) further contends that corporate governance regulations have been used to align the actions of the management with the interest of shareholders to ensure that their goals are in congruence with those of the firm. All the above assessments are effectively intertwined because their goal is one and the same – maximization of shareholders' wealth.

The importance of each of the above assessments solely depends on the situation the firm finds itself in. If a firm has adequate investment opportunities but experiences problems on how the resources should be directed and controlled so as to maximize shareholders wealth, then corporate governance is superior to the firm, at that juncture. The essence being that no financial function or decision is superior to others. For example the choice of how a company is financed, its performance and major financial decisions and events, such as takeovers and initial public offers are linked to the effectiveness of various governance mechanisms the company has put in place. Responsible corporate governance and the existence of legal and regulatory structures that protect investors and lenders explain many of the responsibilities and functions of financial managers hence making corporate governance be considered as finance function (Broyles, 2003). According to Bain and Band (1996) 'the central concern of governance is to add value to as many organizational stakeholders as is practicable…that by having appropriate standards of governance the long-term performance is raised and total shareholder return is enhanced'.

However, the central problem in corporate governance has been construction of rules and putting in place incentives that effectively align the behavior of agents with the desires of principals (Hawley & Williams, 1996). Firms are considered to be nexus of contracts between different parties. The most important of these contracts being that between managers and shareholders (Watts & Zimmerman, 1986). The effect of separating management and ownership; and the resulting governance problems have been recognized in finance theory, in the work of (Berle & Means, 1932; Jensen & Meckling, 1976). This is commonly referred to as principal-agent problem. This problem may lead hired managers to maximize their own utility rather than that of the firm. Due to the extent of business relationships that give rise to agency relationships, investors are skeptical that managers make decisions which are of benefit to them (Mansourinia *et al.* 2013).

To make sure that managers work in the best interest of the shareholders, shareholders of the firm have to incur agency costs (Spong & Sulivan, 2011). Financial economists all over the world have been very much concerned with ways to reduce these agency costs. This is because, when managerial self-dealing are unwarranted and are left unchecked, they can have serious negative consequences on corporate values, performance of the firm and may interfere with proper functioning of capital markets. Hence, the main question at hand has been "How do shareholders know that the assets they own are not being mismanaged, or even embezzled?"(Monks & Nell, 2004). To prefer an answer to this question, different mechanisms are proposed in finance literature; the most fundamental being corporate governance. Corporate governance has been defined in different ways; Shleifer and Vishny, (1997) define corporate governance as ways in which suppliers of finance to corporations assure themselves of getting a fair return on their investment. Rezaee, (2009) on the other hand, defines ccorporate governance as a process through which shareholders induce the management to act in their best interest

by providing a degree of investor confidence that is necessary for the firm and capital market to function effectively. Cadbury, (1992), define corporate governance as: the system by which companies are directed and controlled and is concerned with the distribution of rights and responsibilities among stakeholders, such as the board, management, shareholders and other stakeholders. For the purpose of this study the definition by Shleifer and Vishny, (1997) was adopted.

The main objective of good governance framework is to maximize contributions of firms to the overall economy including other stakeholders (Claessens, 2003).With the driving force behind success being though not limited to: private market investment based activities that are anchored on technological progress, opening up of financial markets and undertaking trade liberalization among other structural reforms. This is because long outstanding institutions on corporate governance arrangements have been characterized by inconsistencies and gaps hence necessitating the need for good corporate governance that would help create decision structures that can prevent the agent from engaging in activities that expose the principal to higher risk than desired (Matengo, 2008; Ciancanelli & Gonzalez, 2000).

Begum and Bhuiyan, (2012) find that in the area of corporate governance practices in banks there are three aspects of literature: one that focuses on how corporate governance in banks differ from those in non-bank firms, the other that looks at how better corporate practices can facilitate banks' financial development and growth and finally that which looks at corporate governance practices in banks from the perspective of their performance and efficiency in operations. To achieve the objective of the study the researchers focused on the last literature aspect. Trabelsi, (2010) on the other hand classifies corporate governance mechanisms that serve to monitor activities in banking firms into four major categories namely: ownership monitoring mechanisms (block ownership, institutional ownership, and managerial ownership), internal corporate

monitoring mechanisms (separate leadership structure, board size, and board independence), regulatory monitoring mechanisms and disclosure monitoring mechanisms. This study sought to analyze the relationship between corporate governance and performance of commercial banks in Kenya based on the first two classification (internal corporate monitoring mechanisms and ownership monitoring mechanisms) by employing selected internal corporate governance mechanisms, ownership monitoring mechanisms and performance measures.

Different modes of firm ownership influence firm's corporate governance which in turn affects performance in different ways. According to Mork *et al*. (1988), higher block ownership positively impact on firm performance. However, Denis, (2001) find that as block holders seek to increase the value of the firm, they may enjoy benefits that are not available to other shareholders hence reducing the liquidity of stock and supply of information to the market that subsequently impact on firm performance negatively. The above findings are in line with those of Mohammad and Shahid, (2012) that there is a negative relationship between institutional ownership and bank performance. Ramzi, (2008) and Le *et al*. (2006) all agree on the important role of institutional shareholders in monitoring the activities of managers in firms. There are findings in finance literature to the effect that independence of the companies' boards enhances firm value and performance though they have significant negative relationship with short term debt (Coleman, 2007). Morck, (2007) further find that independent directors rarely blow the whistle on mismanagement to the firm's assets perpetrated by executives. This in effect negatively impacts on firm performance. Board size as a governance mechanism has been found to impact on firm performance in different ways. Larger board sizes have been found to bring on board a wealth of expertise and experience in decision making processes that make the CEO not to dominate the entire process (Zahra & Pearce, 1989). However, such boards may be slower in decision making process which may in turn

negatively impact on firm's financial performance by way of reduced earnings per share (Andres *et al.* 2005).

On overall, the above corporate governance mechanisms may improve the firm's performance in the following related ways: with better oversight, managers are likely to be more vigilant and will invest the company's funds in value maximizing projects leading to increased shareholders wealth. On the same token, the company's management will not expend fewer available resources in non-productive investment ventures such as: consumption of perquisites, empire building and shirking. Better governance will cut down incidences of asset tunneling, asset stripping, levels of related` party transactions and other forms of asset diversions that negatively impact on performance. This implies that, with good corporate governance investors are better protected and are subjected to less risk of losing their assets; hence they may accept a lower rate of return on their investment; which may translate into a lower cost of capital for the firm that can enhance its ability to access external financing. The above outcomes of better corporate governance translate into higher cash flows that can be reflected in the firms' value and performance (Uwuigbe, 2012).

Studies on corporate governance in banking firms have revealed the critical role banks play in economic progress of any nation. Therefore it is on the onus of the government to assume a central role in managing banks through a regulator who is charged with the responsibility of 'keeping banks safe" given that banking crises in any part of the world dramatically manifests the enormous negative effects of failure in corporate governance practices generally. Banks are more prone to corporate governance risks than other firms due to the following reasons: heterogeneity of exposures, complexity of their business, high level dependence on technology and the judgment driven nature of their business that increases the scope of managerial entrenchment. On the same token, the magnitude of shift of risks, private benefits and absolute misuse of power is more pronounced in

banking firms than any other kinds of firms. Just as it is for any other forms of firms, the value of the banks' shareholders can ensue from increased risk-taking behavior by the management at the expense of debt claimholders and the government. Hence there is need to put in place a good corporate governance mechanism that will protect the interest of all the stakeholders in this important sector.

### 1.2 Statement of the problem

The concept of corporate governance of banks and very large firms have been a priority on the policy agenda in developed countries for over a decade and is warming itself as a priority in African continent (Uwuigbe, 2012). Agency theory and many other corporate governance mechanisms suggest that good corporate governance improves firm performance (Garcia-Marco & Fernandez, 2008). However, global events concerning poor performance and eventual collapse of high profile companies such as Enron, World.com, Bank of Commerce and Credit International, Parmalat among others have awakened need to strengthen corporate governance in both developed and developing countries (Sanda, *et al.* 2005). Due to the importance of corporate governance, the Basel II committee on banking underscored the need for commercial banks to embrace uniform corporate governance practices for the sake of fostering stability and performance in this important sector. Notwithstanding the above measures, in Kenya between 1984 and 2005, 34 bank failures were recorded all the being attributed to poor performance (Upadhyaya, 2011). Poor performance as identified by various studies has been identified with failure to adhere to corporate governance practices. Conversely, in less than one and a half decades (between 2000 and 2013) Central Bank of Kenya has issued three major guidelines on corporate governance to commercial banks: 2001, 2006 and 2013. From the on-going it can be realized that if the problem of poor corporate governance is not addressed more bank failures are imminent. Bank failures are known to generate negative externalities in a country for two reasons: they destroy specific capital leading to further contagion losses in the system. On the same token, bank

closures reduce economic welfare in a country because they create loss of relationship between banks with their clients and specific knowledge of management and risk preferences required to improve performance (Myron *et al.* 1999). The costs of bank closures are also quite enormous because they may spread throughout the entire banking system hence amplifying negative effects on unrelated intermediaries. Based on these findings, Linyiru, (2006), argues that even though there is awareness and existence of corporate governance mechanisms in the Kenyan banking sector, there is need to strengthen these practices owing to the special nature of banks.

Recent findings in studies on the relationship between corporate governance and performance in banking firms in different parts of the world are inconclusive or even contradictory. Love and Rachinsky, (2007) find a negative relationship between corporate governance and bank performance. Among the Kenyan studies Kiruri, (2013) finds that ownership concentration and state ownership in banks lead to lower profitability while higher foreign and domestic ownership lead to higher profitability, Nyarige, (2012), finds that board size affects market performance of commercial banks listed at the NSE negatively whereas board independence affects market performance of these banks positively, Mangu'nyi, (2011) finds that there is no significant difference between banks ownership structure, financial performance and corporate governance practices commercial banks in Kenya have put in place. These contradictions in findings could create aspersions as to whether corporate governance impacts on performance of commercial banks in Kenya. Prowse (1997) finds that research on corporate governance as applied to financial institutions and intermediaries especially banks, are scarce. These findings are supported by Malherbe and Segal (2001) and Arun and Turner (2002) who find that although the subject matter has received a lot of attention in developing countries of late, corporate governance studies on banks has almost been ignored by researchers. Similar sentiments are echoed by Macey and O'Hara (2002) that even in developed economies, corporate governance of banks has only been discussed in recent

literature. In view of the above findings, Al-Manseer *et al.* (2012) conclude that more research needs to be conducted on corporate governance in the banking sector. It is these pretexts that this study sought to analyze the relationship between corporate governance and performance of commercial banks in Kenya using specific internal corporate monitoring mechanisms and ownership monitoring mechanisms as proxies of corporate governance, return on asset, return on equity and Tobin's q ratio as performance indicators and bank size as a control variable; to determine what constitutes the best measure of performance in the study of corporate governance in the Kenyan banking sector, remove aspersions created by various studies on the relationship between corporate governance and performance in the Kenyan banking sector in view of continued bank failures and contribute to the existing literature on governance performance linkage.

## 1.3 Objectives of the study

### 1.3.1 General Objective

The general objective of the study was to analyze the relationship between corporate governance practices and performance of commercial banks in Kenya.

### 1.3.2 Specific Objectives

This study also sought to achieve the following specific objectives:

1. To evaluate the influence of block ownership on performance of commercial banks in Kenya.
2. To determine the relationship between institutional ownership and performance of commercial banks in Kenya.
3. To ascertain the effect of board independence on Kenya's commercial banks performance.
4. To identify the relationship between board size and performance of commercial banks in Kenya.

5. To establish the effect of bank size in the relationship between corporate governance and performance of commercial banks in Kenya.

### 1.4 Research Hypotheses

In order to prefer useful answers to realize the objectives of the study, the following null hypotheses were tested.

**$H_{O1}$:** There is no significant relationship between block ownership and performance of commercial banks in Kenya

**$H_{O2}$:** There is no significant relationship between institutional ownership and performance of commercial banks in Kenya

**$H_{O3}$:** There is no significant relationship between board independence and performance of commercial banks in Kenya.

**$H_{O4}$:** There is no significant relationship between board size and performance of commercial banks in Kenya.

**$H_{O5}$:** The relationship between corporate governance and performance of commercial banks in Kenya is not significantly affected by bank size.

### 1.5 Significance of the study

The findings of the study focused at understanding and improving the relationship between corporate governance and performance of commercial banks in Kenya. While empirical results are to provide general corporate governance indicators useful to Central Bank of Kenya and the business community in formulating policies and making informed decisions. The Regulator (CBK) and Decision makers at the various levels of management in commercial banks will gain value added information on corporate governance from this study as a key enabler of developing the financial and economic

perspective of individual banks and the entire banking industry in Kenya that will foster their performance. The government of Kenya will also be able to understand the politics behind corporate governance of banks that will assist it improve on areas that negatively impact corporate governance through CBK with a view of enhancing productivity and performance.

The management of commercial banks in Kenya will benefit from the findings that will help them enhance responsible governance which leads to sustained productivity and better performance. This study will also enable commercial banks identify the best corporate governance practices internationally and look into how such can be integrated in their business practices to enhance performance. The study further aimed at improving the literature on governance-performance linkage by providing a survey of the Kenyan banking industry for the period spanning (2001-2013) and ascertains which of the three performance indicators adopted in the study is the best measure of performance in as far as studies on corporate governance and performance of commercial banks in Kenya is concerned. Kenya provided a potentially valuable environment for the study given that it represented one of the most relevant developing country based on its experience along its banking system, many problems in terms of stability and reputation that have been witnessed.

Those in the academic realm need not to be forgotten. Future researchers and academic institutions, especially those of higher learning can use the findings of this research as a source for future reference. Thus the study will serve as a data base for further research.

### 1.6 Scope of Study

The last decade provided a wake- up call to the banking sector worldwide following the Asian financial crisis of late 90's and the global financial crisis of 2007 that took toll on

world economies. These two crises have been attributed to poor corporate governance. In view of above, Central Banks and Reserve banks worldwide were compelled to enforce corporate governance measures among their membership banks to counter the negative effects of these crises and obviate any chance of such occurrences. The choice of the banking sector for study was underlined in the fact that the sector's stability has a large positive externality and it has key institutions that maintain the payment system in the economy that are essential for financial stability and economic wellbeing. To this end, the study was essentially a survey on 43 commercial banks incorporated and were operating in Kenya during the period.

The researcher was cognizant of the fact that underlying behavior of individual banks could have had an effect on performance variables hence skewing regression results. However, most of these effects were catered for through adoption of bank size as a control variable. The study covered the period spanning January 2001 to 31, December 2013. The choice of the period allowed for a significant lag period for banks to have reviewed and implemented various recommendations made by Central Bank of Kenya as spelt out in various prudential guidelines on corporate governance for institutions licensed under the Banking Act Cap 488 that had been issued.

The choice of January, 2001 as the starting point of the study was informed by the fact that this was the effective date when corporate governance guidelines for banking firms were first issued by CBK. In 2006 extremely comprehensive corporate governance mechanisms that superseded the 2000 that were relatively simple were introduced by Central Bank of Kenya. They focused on: the duties responsibilities and code of conduct for shareholders, directors, chief executive officers and management of banking institutions. In 2013 new prudential guidelines that superseded the 2006 were issued by CBK.

## 1.7 Limitations of the study

Although corporate governance in Africa is of good start, insufficient empirical research has limited the basis of comparison of the effectiveness of the continent's corporate governance outcomes with other continents and even between and amongst different economic sectors in countries. There are numerous variables of corporate governance that companies should strive to understand their underlying effects on their performance. These are: board of directors, audit committees, executive and ordinary director compensation, insider ownership, director characteristics, corporate by-laws and progressive practices among others. However, data availability, accessibility and measurability had an influence on the choice of corporate governance variables that were adopted in this study taking into consideration the difficulty that one can encounter in modeling some of these variables. In addition, most governance variables conjecture substantial measurement errors and thus can create a danger in modeling that has an implication on reliability and interpretation of final results. It is in this context that the researchers restricted the study to specific bank ownership and board related structure variables bearing in mind that collecting data on some of these variables can be daunting task especially in circumstances where some respondents fail to respond to them subsequently leading to their exclusion from the study.

Although the study assumed that good bank performance was anchored on corporate governance, it did not rule out the fact that some other variables such as political instability, corruption and bureaucracy could be critical in determining bank performance in Kenya. However, given that the study of corporate governance is important it was expected that a well-structured corporate governance mechanism could result in a reduction of all these vices subsequently leading to increased accountability, transparency and improved performance. These limitations however did not compromise the validity of the conclusion on the findings of this study.

Several explanations have been pre-arranged for apparent inconsistencies in findings from related studies on the relationship between corporate governance and firm performance. Some researchers contend that the problem lies in the use of either publicly available data whose scope is limited, others argue that there is restrictive use of performance measures, whereas others argue that empirical literature on corporate governance considers the relationship between corporate performance and ownership in most cases using two variables at a time. However, this study provided a solution to these problems by using three dependent variables as performance indicators, four independent corporate governance variables and one control variable. The use of return on asset (ROA), return on equity (ROE) and Tobin's q as performance measures were in tandem with the arguments that suggests that the use of only accounting or market measures are responsible for inconsistencies in establishing a clear relationship between corporate governance and corporate performance of firms (Bocean & Barbu,2005).

# CHAPTER TWO

# LITERATURE REVIEW

## 2.1 Introduction

This chapter presents a review of related literature under the following headings: Theoretical review, Conceptual framework, Empirical studies, Critique of existing literature relevant to the study, Research gaps and Summary.

## 2.2 Theoretical Review

For corporate governance issues to arise in an organization, two conditions must be present: there should be an agency problem and the transaction costs should be high such that the agency problem cannot be dealt with through a contract Hart, (1995); hence need for corporate governance that will create checks and balance that will ensure that contracts between the organization and its members are complete. The second condition is that: corporations should be big in size; due to the big size, they are run by professional managers or agents who are accountable to dispersed shareholders or principals. In publicly owned companies there are often a large number of small scattered shareholders who hold control rights through voting though their votes are too few to play any significant role in controlling the day to day business activities of the firm. In view of this; these small shareholders delegate their powers to board of directors that subsequently delegates the day –to –day control of the company to the management (Berle & Means, 1932).

### 2.2.1 Agency Theory

Empirical studies on corporate governance have been based on agency theory perspective this is because corporate governance has a root in agency theory (Filatotchev & Wright 2011). The principal-agent relationship originates when a principal hires an agent to perform a service or to act on his behalf (Jensen & Meckling, 1976). Managers

in a firm are agents of shareholders who assume that the principle guiding them are those geared towards maximization of shareholders wealth. However, there are three factors that disturb this relationship. In the first place, there is conflict of interest between the principal and the agent. The agents may strife to maximize their own utility at the expense of the principals, secondly, the presence of a high level of information asymmetry between the principal and the agent and the possibility that the agent can take advantage of this information asymmetry to enrich themselves and lastly the inability of the principal to ensure that the agent acts in compliance with his or her interests that makes it impossible or too expensive for him or her to monitor the efforts of the agent as illustrated in figure 2.1 below;

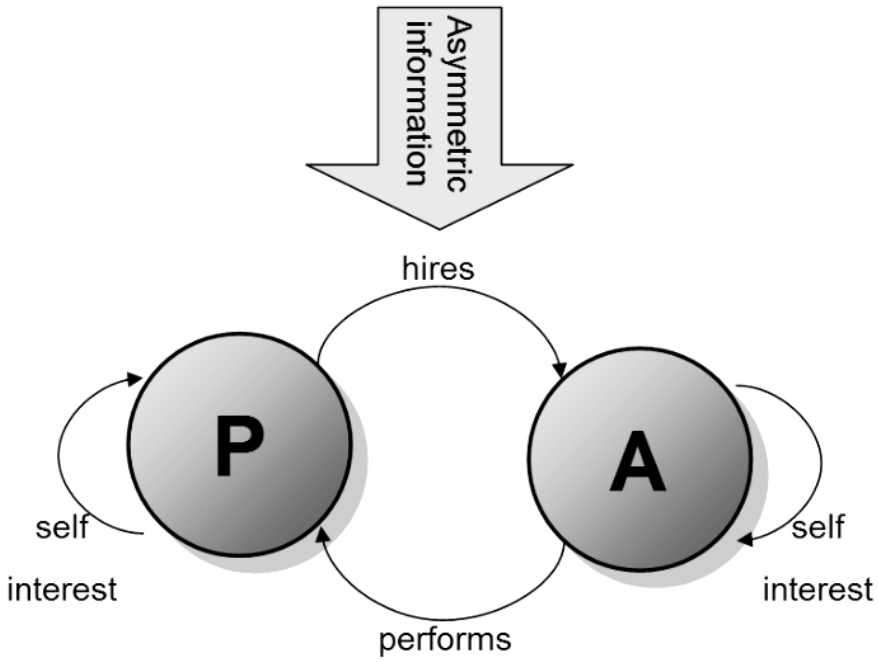


**Figure 2.1: Klein (2009): Principal-agent problem**

The divergence behavior between the interests of the principle and those of the agent give rise to agency costs. The idea behind agency theory is to select whatever

mechanism that will regulate the relationship between the agent and the principal in a manner that will ensure alignment of the interests of the two parties leading to reduction of agency costs. These mechanisms may take form of contracts that may be implied or written that are based on a number of assumptions about: people (self-interest, limited rationality, risk aversion), organizations (goal conflict between organizational members) and information (non homogeneous that can be acquired at a certain cost).

Both theoretical and empirical studies point at four areas that are problematic in agency relationship these are: moral hazard, earning retention, risk aversion and time horizon. Moral hazard relates to a situation whereby the agent may deliberately fail to perform as per contractual terms. It has been noted that a firm's manager incentive to consume perquisites increases when he or she does not own shares in a company or when his or her share ownership in the company declines (MColgan, 2001). For such managers instead of not investing shareholders funds, they may choose to invest in investment projects that are best suited to their personal skills and knowledge. Though such investments may increase the value of the firm, they also increase the cost of replacing such managers due to increased entrenchment effect (Jensen & Meckling, 1976).

Jensen, (1986), argues that there is earning retention conflict between managers and shareholders of a firm. Whereas managers would prefer to retain company's earnings with a view of investing in next available positive net present value projects shareholders would prefer higher returns in form of cash dividends paid to them. This scenario is more prevalent in companies characterized by fewer internal positive net present value investment opportunities. Managers in these companies stand to benefit from retained earnings in the following related ways: high amount of retained earnings grants them a larger power base, large retained earnings provides them with greater prestige and large retained earnings can provide them with the ability to dominate the board and award themselves higher remunerations.

Managers of companies who are risk averse prefer higher equity financing in their companies' capital structure than debt. This is because debt increases the risk of default and bankruptcy that may expose their weaknesses. In absence of sufficient equity they would prefer use of retained earnings in their financing plans. Despite the fact that retained earnings as a source of financing, reduces need for external financing; in case managers require more funds for investment purposes they have to go to the external markets where they have to incur floatation costs. These costs are known to provide a useful monitoring mechanism that constraint a manager from investing in negative net present value projects. Jensen, (1993, 1986), argue that firms' managers prefer earning retention and may invest them for the purposes of diversifying the firms risks. However, Lang and Stulz, (1994), find that returns to shareholders in undiversified firms are greater than those from firms whose shareholders have attempted to reduce their risk exposure through diversification and that the value of diversified firms is reduced as they are diversified further.

Whereas shareholders prefer future strings of cash flows over a long period of time, the management of the company may be interested in cash flows generated within their term in office. This gives rise to time horizon agency conflict that makes them incline towards high return short-term investments at the expense of long-term positive net present value investment projects. Dechow and Sloan, (1991), find that investment in research and development and investment in fixed assets by a company reduces in the final years of the CEO in office. This could be attributed to the fact that such a CEO will not be around to benefit from future benefits that will accrue from such investments. At the same time, the management of the firm may also engage in creative accounting practices with a view of manipulating earnings prior to their exit from office in an attempt to maximize their performance based bonuses (Weisbach, 1988).

Managers in a firm are bound to avert risk when their interests and those of the shareholders are well aligned and when cash flow hedging is properly used. In this case, sufficient funds will be available to finance positive net present value projects that are available hence increasing shareholders' wealth. Conversely, in presence of extreme conflict between the management and shareholders' coupled with improper cash flow hedging, the management of the firm will only be able to secure funding for projects that will actually destroy shareholders value and wealth (Fatemi & Luft, 2002). This problem may be heightened in circumstances where the CEO's compensation is composed of fixed salary or where the CEO posses' specific skills that are difficult to transfer from one company to the other (McColgan, 2001).

To limit the agent's diverging behavior as illustrated in figure 2.1, the principal has to structure the contract in such a manner that will give the agent incentives to take actions that are consistent with the firm's interests and monitor the agent's behavior over the life of the contract by incurring agency costs. Where agency cost is the sum of monitoring expenses, bonding costs and residual loss. Monitoring costs are expenditures incurred by the principal to measure, observe and control an agent's behavior (McColgan, 2001). They constitute of: audits costs, budget restrictions, writing executive compensation contracts, establishment of operation rules and the ultimate cost of firing the firms' managers. In the long run, monitoring costs are paid back by the agent through adjustments that are made on their compensations (Fama & Jensen, 1983). Kenyan legislative practices and prudential guidelines on corporate governance issued by CBK also serve as monitoring aspects. However, for the monitors to be effective, they should posses the necessary expertise and incentives to fully monitor activities of the management.

At times, the agent will expend resources to guarantee the principle that he will not take certain actions that will be detrimental to the principals' interest and in case such actions

happen, the principal will be compensated by the agent. The cost of establishing and adhering to these systems are what sums up to the bonding costs. Examples of bonding costs include: offering a guarantee and investing in reputation. Under normal circumstances the agent will stop incurring bonding costs when marginal reduction in monitoring costs is equivalent to the marginal increase in bonding costs McColgan, (2001); taking into consideration the fact that the optimal bonding contract entered between the agent and the principal should be one that will entice managers to make decisions that will maximize shareholders wealth (Denis, 2001).

Even after shareholders have incurred monitoring and bonding costs, the interests of managers and shareholders are likely not to remain in tandem. There will remain some agency losses arising from conflict of interest between the two parties known as residual loss. This may arise as a result of high costs that may be incurred in enforcing agency-principal contracts which far outweigh the resultant benefits. For example due to the big size of firms the managerial aspects may not capture all aspects of every state of affair resulting in a residual loss. Residual loss is represented by a trade-off between overly constraining management and enforcing contractual mechanism to reduce the agency problem (McColgan, 2001).

In the banking firms' agency problem takes a different dimension. This is because; the areas of conflict involve more than two parties at any given time (shareholders, management and the government/regulator). Banks shareholders may invest more or less capital contrary to the stipulated requirements by the regulator with a view of exploiting other suppliers of funds who mainly constitute of minority shareholders and institutional investors who may hold a substantial number of shares. Institutional investors have enough powers to monitor and control managers to the extent that the management can reveal some secretive information to them that they can use to exploit minority shareholders (Bhattacharya *et al.* 1998). Based on these state of affairs the government is

forced to take up the role of the regulator through Central Bank or Reserve Bank with a view of protecting the interest of minority shareholders and other stakeholders.

### 2.2.2 Stewardship Theory

If anyone is to consider a theory that can motivate managers, stewardship theory comes in handy as alternative to agency theory. Stewardship theory replaces absence of trust in agency theory with respect to authority and fondness to ethical behaviors geared at boosting firm performance (Clarke, 2004). The ultimate intention that drives managers to accomplish their jobs is underlined in their desire to perform satisfactorily. Managers are conjured up as being motivated by: the need to achieve, the need to gain intrinsic satisfaction through successfully performing challenging tasks and the need to exercise responsibility and authority that makes them gain recognition from their peers and seniors (Donaldson & Davis 1991). The main objective bestowed on managers in a firm is primarily to maximize shareholders wealth. It is widely acknowledged that, this objective can well be achieved when firms under their management perform exemplarily well. Davis *et al.* (1997) contend that managers left on their own will act as responsible stewards of the company's assets under their control. Stewardship theorists further argues that there is need for organizations to put in place structures that allow harmonization of objectives that managers and shareholders of firms need to achieve if superior performance is to be realized.

Stewardship theory not only focuses on the CEOs' motivation but rather on facilitative empowering structures that fusion the incumbency roles of the chairman and CEO of the company that enhance effectiveness leading to achievement of superior performance. Stewardship theorists argue that smaller board sizes promotes increased participation and social cohesion whereas larger board sizes inhibits the board's ability to reach a consensus on important decisions (Muth & Donaldson, 1998; Yermack, 1996). They

further argue that: executive-dominated boards should be favored by organizations because of their depth of knowledge, ability to access current operating information and their technical expertise and commitment to the firm that potentially impact on performance positively (Letting' *et al.* 2012; Muth & Donaldson, 1998). Central Bank of Kenya advocates for a board of whom 3/5 of the members should be independent directors drawn from diverse professions and 1/3 of whom should be women as a source of diverse professional opinions and to cater for gender parity that may be required for smooth running of banks and enhanced performance CBK (2013).

### 2.2.3 Resource Dependency Theory

The proponents of resource dependency theory argue that there is need to have environmental linkages between the firm and outside resources (Wan & Idris 2012). These environmental linkages can help the firm reduce the levels of transaction costs associated with environmental interdependency (Williamson, 1985). Several factors have been known to intensify the character of these dependences. They include: the importance of the resource, the relative shortage of the resource and the extent to which the resource is concentrated in the environment (Wan & Idris, 2012). Resource dependency theory strongly emphasizes the role of the board in providing the much needed resources to move the firm to the next level. The theory further recognizes the role of the administrative arm as a link between the firm and the resources required to accomplish its goals (Tricker, 2012).

Resource dependency theory further points to the fact that organizations tend to reduce the risks of external influences by ensuring that resources are available for their survival and growth. Therefore, the issue of effectiveness of the executive and non-executive directors on firm performance is irrelevant. What is relevant is the directors' of the firm's presences on the board of many other companies. This enables companies establish relationships that can help them access information that can be utilized to their

advantage. In view of the fact that much of these resources are scarce and unevenly distributed, it is only through inter-dependent organizational relationships that organizations can share these benefits (Hitt *et al.* 2012). This implies that, boards of directors in a company are an important mechanism that absorbs critical elements of environmental uncertainty that can help reduce transaction costs associated with environmental interdependency. Taking into account the fact that substantial amounts of resources available in a country are either directly or indirectly controlled by the government, appointing directors to the company's board who have influence and are able to access key policy-makers and government offices is seen as an important milestone for the company's survival and success (Pfeffer, & Salancik, 1978). In Kenya CBK (2013) recommends a bigger board size with a minimum of five directors of whom 3/5 should be independent directors drawn from diverse professions and working environments so as to aid in decision making during board meetings (CBK, 2013).

### 2.2.3 Transaction Cost Economics Theory

The firm can be viewed as a governance structure whose governance problems are perceived to start from a number of contractual hazards. These include: self-interested opportunism, information asymmetries, asset specificity, small number bargaining and the problem of bounded rationality (Learmount, 2002). Transaction cost economic theory has overwhelmingly borrowed from the work of Coase (1937) whose main proposition is that; corporations can save costs if they can concentrate on their core business instead of focusing entirely on non core business activities. Based on the above, corporate governance in an organization should help the firm identify internal measures and mechanisms which can economize transaction costs associated with these contractual hazards. The underlying assumption of the transaction cost economic theory is that: firms have become so large such that they have become a substitute for the market in determining the allocation of resources; where the unit of analysis is the

number of transactions processed. It is on this basis that commercial banks in Kenya have since early 2000s concentrated on core business activities and have outsourced non core business activities like: transport, courier service, office premises, training among others.

Under normal circumstances, the firm has two methods of getting control over resources: it can undertake activities in-house or it can outsource. Transaction cost economic theory proposes that the high costs that firms incur in successfully executing transactions at times makes them support in-house production and markets as economic governance structures between two extreme governance structures (Williamson, 1975). The firm can decide to own assets; hence have control on decisions regarding production. In this case, the supply and purchase of assets are made by managers and imposed through hierarchies referred to as hierarchy solution or assets are bought by individuals where the prices at which they will be going for will be guided and coordinated by prices prevailing on the market (market solutions). The decision on which approach to adopt should be guided by quantitative analysis of costs and benefits arising from the decision based on comparison of transaction costs (Lamminmaki, 2010).

Transaction costs can occur when the firm is dealing with external or internal parties in an organization. Transaction costs that can occur when dealing with an external party may take the form of: cost of search and information incurred to find a supplier, bargaining and decision costs incurred in order to purchase a component and policing and enforcement costs incurred to monitor the quality of output. The way a company is organized will determine its ability to control its volume of transactions and hence the overall costs of producing goods and services. It is always in the interest of the company's management to internalize much of its transactions so as: to eliminate transaction costs, reduce resulting risks and uncertainties about prices and improve the

quality of products and services produced. Transaction costs can further be impacted to by: bounded rationality (the limited capacity of one to understand business situations, which limits the factors he or she should consider in decision making) and opportunism (the actions taken in an individual's best interests that can create uncertainty in dealings and mistrust between parties). The significance and impact of these criteria allows the company to make decisions on whether to expand and produce services for its consumption internally or outsource such services. In this case, the variables dictating the impact on the transaction costs being: frequency (how often such a transaction is made), uncertainty (long term relationships are more uncertain, close relationships are more uncertain, lack of trust leads to uncertainty) and asset specificity (how unique the component is for your needs). Transaction costs that occur internally relate to those made between business units on an in-house basis. Regardless of which stream of literature is examined, the underlying theme for transaction costs is the notion of ignorance (Allen, 1999).

The concepts of bounded rationality and opportunism on the part of directors or managers in different business units of a firm also applies when one is to view the motivation behind either of the decision. The three variables that dictate the impact on transaction costs are: asset specificity (amount the manager will personally gain), certainty (or otherwise of being caught) and frequency (endemic nature of such action within the corporate culture). The degree and impact of these three variables helps in determining the degree of monitoring and control required by the senior management in reducing these transaction costs since the opportunistic behavior by managers in the business unit can discourage potential investors. Therefore it is vital for businesses organizations to organize themselves in a manner that will minimize the impact of bounded rationality and governance costs by building up internal controls monitoring mechanisms that will make managers be more risk averse by seeking safe grounds of easily governed markets (Tricker, 2012).

The distinctions, convergences and relevance in the main theories that have shaped the development of corporate governance are as summarized in table 2.1:

**Table 2.1: Comparisons of Corporate Governance Theories**

| **Basis** | **Agency theory** | **Stewardship theory** | **Resource dependency theory** | **Transaction economics theory** |
|---|---|---|---|---|
| **Focus** | Self-interest | Shareholders interest | Resources and power | Transactional costs |
| **Objective** | Minimize agency cost | Maximize productivity | Acquisition and exploitation of resources | Minimize transaction costs |
| **Attitude towards risk** | Risk aversion | Risk aversion | Risk aversion | Risk aversion |

From the four theories in table 2.1 above, the attitude towards risk is the same (risk aversion). Based on the objective of each of these theories, one realizes that they are all relevant as they are all geared towards shareholders wealth maximization- a classical objective of finance on which this study is anchored. However, the most recognized theoretical perspective applied in corporate governance studies that has received a lot of attention from academicians as well as practitioners and has provided the basis for governance standards, codes and principles developed by many institutions is agency theory (Basel 2010, OECD, 2004, Basel 1999, Dalton *et al.*1998, Shleifer & Vishny, 1997, Fama & Jensen, 1983; Jensen & Meckling, 1976). Based on the above comparisons and findings, agency theory framework was adopted for this study because if managers left unchecked they can have serious negative consequences on corporate values, performance of the firm and may interfere with the proper functioning of capital markets.

## 2.3 Conceptual Framework

The conceptual framework model was developed from the literature review and it shed light on the methodology that was used in the study. It assumed that banks performance was affected by the following aspects of corporate governance: internal corporate monitoring mechanisms (board independence and board size) and ownership monitoring mechanisms (block holding, institutional ownership). There is ample evidence in finance literature that supports the fact that bank performance is affected by block ownership and higher levels of institutional ownership. The higher the levels of block ownership and institutional ownership in banks' the more effective would be the banks' corporate governance and performance. Related literature also support the proposition that the presence of more independent directors on the banks' board and small board sizes lead to better corporate governance and bank performance. For the purpose of this study, the variable bank size was adopted as a control variable of bank specific characteristics. The corporate governance mechanisms adopted in the study that are geared towards improving banks performance directly or through minimizing agency costs which if not checked negatively affects performance. Since the general objective of the study was to ascertain the relationship between corporate governance and performance of commercial banks in Kenya, the performance measures adopted were those that are widely used by listed companies and banks namely: return on equity, return on assets and Tobin's q ratio (Heentigala & Armstrong, 2011). Figure 2.2 illustrates the conceptual framework.

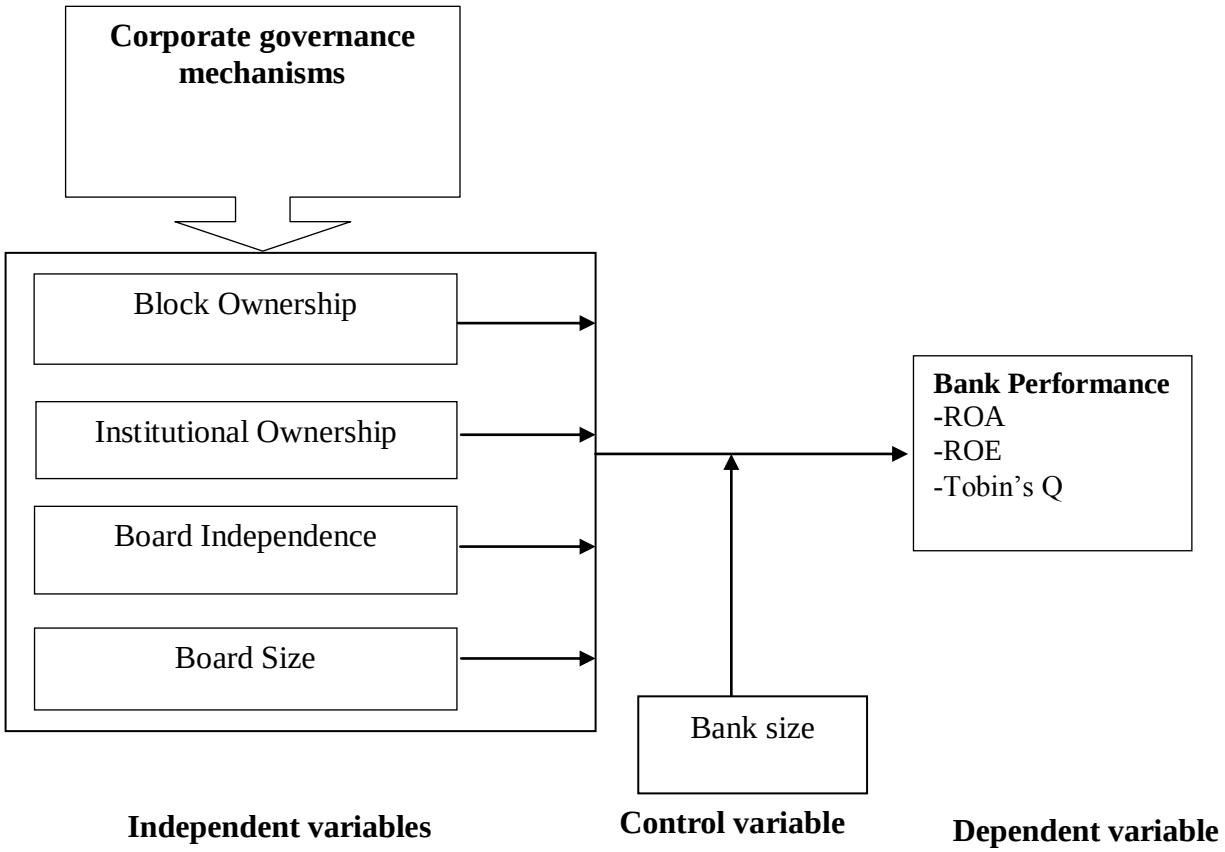


**Figure 2.2: Conceptual Framework**

Independent variables were those related to agency theory and corporate governance as presented in the conceptual framework (figure 2.2) that were measured as follows: Block ownership was computed as the total firm's outstanding shares owned by block holders, defined as the sum of the three largest stakes in the bank's equity (Stepanova & Ivantsova, 2012), Institutional ownership was measured as % of shares held by institutions as disclosed in annual financial reports, board independence was calculated as the ratio of non executive directors to total board size, board size was measured by the logarithm of the number of board members and bank size was measured by the logarithm of total banks assets.

Bank performance measures as spelt out in the conceptual framework figure 2.2 were measured as follows: return on asset was measured by the ratio of profit before tax to total assets of the bank; return on equity was measured by the ratio of net income (profit after tax) to shareholders equity of the bank. TBQ ratio for quoted commercial bank was measured by the ratio of market value of the bank's equity to its net worth. For unquoted banks the value of the bank's equity was estimated by multiplying the current price of a quoted bank (one with net worth that is close to that of unquoted bank) with the ratio of unquoted bank funds to own funds of quoted bank. Where own funds of unquoted bank and funds of a quoted bank were measured on the same day (Durant & Massaro, 2004).

A number of corporate governance mechanisms have been proposed by various studies to ameliorate the principal-agent problem between managers and shareholders in banks with a view of improving performance. Employing these governance mechanisms would make managers to better align their interests with those of the shareholders, hence reducing the level of agency problems. The corporate governance mechanisms/variables as identified in the conceptual framework figure 2.2 are therefore discussed in details as follows:

### 2.3.1 Block Ownership

Good corporate governance in a company depends on a combination of two factors namely: how investors' rights are protected and ownership concentration (Shleifer & Vishny 1997). The ownership structure of the firm is an outcome of shareholders decisions (Demstez, 1983). To maximize the value of the firm may require either concentrated or diffuse ownership structure. This is determined by the trading pattern of shares on the stock exchange or security exchange that may reflect the desire of existing shareholders or potential owners to change their ownership stakes.

Block holder refers to owners of a large volume of a company's shares or bonds who are able to influence the company's decisions by virtue of the voting rights awarded to them. Berle and Means (1932) suggested that there is a positive correlation between block ownership and firm performance. However, some studies have not observed any relationship between the two variables at all. Findings from related studies indicate that, there is positive market reaction to block purchases of companies' shares; however if the acquirer fails to initiate corporate restructuring process this reactions may be short lived a situation profound where the acquisition is for their own value destroying purposes leading to reduction in liquidity of stock and supply of information to the market (Denis, 2001).

The more dispersed the ownership structure of a firm, the higher the agency costs (Jensen & Meckling, 1976). This is because ordinary shareholders may not have time and relevant skills required to monitor the activities of the company's management. In view of this, the high presence of small ownership in a company may give rise to free rider problems (McColgan, 2001). However, this problem can be neutralized by the presence of block holders in the company's ownership structure. In an agency framework, higher block ownership facilitates more active monitoring of management activities and can help mitigate agency costs (Gilan & Starks 2003). The CEOs of firms tend to disclose more information to block shareholders on a voluntary basis than to other parties hence reducing monitoring costs (McColgan, 2001). While examining Czech companies, Claesses and Djankov (1999) find that; the more concentrated the ownership the higher the profitability of a firm. Xu and Wang (1999) find a positive correlation between shareholding ratio of the top ten big shareholders and performance among Chinese firms and Yammeesri *et al.* (2006), in examination of Tai-non financial firms finds a positive relationship between concentrated ownership and performance.

Despite the positive relationships realized between block ownership and performance reported by various studies, block ownership has been known to raise new corporate governance problems especially in banking firms. For instance, large investors may pay themselves special dividends and are able to exploit business relationships with other firms they own at the expense of the bank (Levine, 2003). Aghion and Tirole (1997) find that though concentrated ownership provides incentives to monitor the company's management, it also reduces the managers' initiative to acquire information. Managers are less likely to be active if they know that shareholders are likely to interfere with decisions that they make. Since 90s, careful observation of ownership structures across the world indicate that dispersed shareholdings in firms have become much less frequent paving way for a high degree of block ownership (La Porta *et al.* 1999). Consequently, the potential expropriations of minority shareholders by controlling owners have become a normal occurrence (Gugler & Weigand, 2003).

On examination of the trade-off between ownership concentration and liquidity which may affect the informational role of the stock market Holmstrom and Tirole (1990) and Admati *et al.* (1994) find that high ownership concentration reduces the owners tolerance towards risk. The purchase of shares by block holders can pause a control threat to the company's management as they push for efficiency in the company's internal governance systems. Since block holders widely hold diversified portfolios, further reduction of risk is not in their interest (Denis *et al.* 1997). The threats by block holders on the management can deter them from engaging in non-value adding investment activities by disguising that they are diversifying the company's investment activities for the benefit of the stakeholders. However, if the threats are too severe, they may restrain the managers' initiatives and incentives which eventually may impact on bank performance negatively. In Kenya, the origin of problems bedeviling many companies ranging from errors, mistakes and outright frauds have been attributed to block ownership among others (Ongore & K'Obonyo, 2011). With such an environment

in the back ground the interests of minority shareholders could be compromised in favor of majority shareholders. Similar findings are made by Nyururu, (2013) that there is a negative relationship between ownership concentration and commercial banks performance in Kenya.

Demsetz and Lehn (1985) examined the relationship between accounting profit rate and the percentage of shares owned by the top ten companies in the U.S. where ownership structure was treated as an endogenous variable. They found that there is no relationship between ownership concentration and performance in these companies. Related findings were made by Demsetz and Villalonga (2001) that while exacerbating some agency problems in a firm, diffuse ownership also yields compensating advantages that generally offset problems. Chen *et al*. (2005) finds that concentrated ownership is not associated with better performance or higher valuation of the firm when comparisons are made. Ermina and Maria, (2010), Mang'unyi, (2011) and Al-Hawary, (2012) also find that there is no relationship between block ownership and performance of commercial banks.

### 2.3.2 Institutional Ownership

Institutional investors are organizations which marshal large sums of money that they invest in companies. They take the form of; banks, mutual funds or insurance companies among others. Due to their ability to influence the board decisions, absorb monitoring costs and engage in active ownership of the firm, their presence might positively affect firm performance. Institutional investors are known to play a very critical role in the debate on company's shareholder value creation as they will always strife to maximize shareholder value (Hellman, 2005).

The Cadbury Committee (1992)-U.K. viewed institutional investors to have a very special role in trying to ensure that their recommendations are adopted by companies;

stating that ‘we look to the institutions in particular……..to use their influence as owners to ensure that the companies in which they have invested in comply with the Code’. Similar sentiments were echoed by Greenbury Report (1995)-U.K. where in one of its main action points states that ‘the investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code’. Similarly, the Hampel Report (1998)-U.K. points out that ‘it is clear……. that a discussion of the role of shareholders in corporate governance will mainly concern the institutions’. These three influential committees on corporate governance matters clearly emphasized the role of institutional investors in companies as far as enforcement of corporate governance issues is concerned. The Combined Code (2003)-U.K. principles of good governance points out that: institutional shareholders should enter into dialogue with companies based on mutual understanding of objectives, when evaluating companies’ governance arrangements, particularly those related to board structure and composition, they should take into account all relevant factors drawn to their attention and they are responsible to make considered use of their votes.

The Hermes Principles of 2002 were issued by Hermes one of the largest and influential institutional investor in U.K. The first principle was that ‘companies should seek an honest, open and ongoing dialogue with shareholders. This clearly reflects Hermes’ intention to have a dialogue with companies in which they have invested in. Similarly, Hermes Corporate Governance Principles (2006), global principle 3 on board of directors, points out that ‘the board is responsible for facilitating a satisfactory dialogue with shareholders.’ The perception of the key role to be played by institutional investors is not only limited to U.K. but has been adopted in other parts of the world Kenya included.

Studies on the relationship between institutional ownership and firm performance provide mixed results. According to Brickley *et al.* (1988) and Kochhar and David

(1996), institutional investors can be categorized into two major groups namely: pressure sensitive institutional investors and pressure resistant institutional investors. Pressure-sensitive institutional investors refer to those institutional investors who are likely to have both investment and business relationships with firms in which they hold equity; they include: insurance companies, banks, and non-bank trusts. For such investors to protect their business relationships, they may be less willing to vote against the decision brought forward by the management. Heard and Sherman (1987) argue that investment and business relationships held by institutional investors could create conflict of interest between institutional investors and the management since the power gained from their ownership may be tampered by their reliance on the firm for business. This raises the likelihood that there will be a negative relationship between high presence of pressure-sensitive institutional investors and firm performance and therefore it is expected that there will be a positive relationship between high presence of pressure-resistant institutional holders and firm performance.

Of late, it has been realized that institutional investors play an active role in companies' corporate governance especially among underperforming firms that are highly diversified (Bethel *et al.* 1988). Their intense purchase of equity stakes in these companies has been followed by divestitures, abnormal share price increases and decrease in merger and acquisition threats. Borokhovich *et al.* (2000) find that the relative holdings in a firm by institutional investors affect market reaction to announcement of antitakeover. Signaling theory proposes that institutional investors can be a credible mechanism that provides a base for information sharing among investors. Signaling theory assumes that an investor can infer information regarding the future performance of the company's stock through a signal that comes from signaling mechanism; these include though not limited to: changes in ownership, leverage and dividend announcements among others. Institutional ownership in a firm is likely to imply advantages to the company in terms of finance, low risk aversion and a relatively

long-time horizon that makes their investments characterized by investment portfolios that have strong relationship with the company they have invested in (Thomsen & Pedersen, 2000).

Pound (1988) and Shleifer and Vishny (1986) argue that; institutional investors controlling large ownership stakes in a company have greater incentive to monitor the management behavior than board of directors who may have little or no wealth invested in these firms. Patibandla, (2006), Leng, (2004) and Dwivedi and Jain (2003) find a positive relationship between high institutional ownership in a firm and profitability. In studies related to banking firms Poudel and Hovey (2012) and Bino and Tomar (2007) all agree that; there is a positive relationship between institutional ownership and bank performance. These findings are in line with those of Mikkelson and Ruback, (1985), Le *et al.* (2006) and Ramzi, (2008), who all agree on the important role of institutional shareholders in monitoring firm performance. In a study of firms facing control problems, it was found that on average an institutional investor was more likely to vote and get involved in firms decision making than the average non-institution investor (Brickley *et al.* 1988).

Woidtke (2002) finds a negative relationship between activist public pension fund ownership and Tobin's q in a firm but a positive relationship between Tobin's q and private pension funds. The positive relationship for private pension funds is attributed to the fact that private pension funds have large amounts of funds to invest for a longer period of time. These funds are not invested in fewer firms because such moves would involve taking unnecessarily high risk. Institutional investors are only willing to hold a large stake in a firm for two reasons: to exercise the private benefits of control and to ensure that the costs and the extra risk that are associated with the large holdings do not override the benefits (Holderness, 2003). This is contrary to the investment objectives of public pension funds.

Maug (1998) finds that the incentive of institutional managers to monitor the firm depends on the size of their shareholding. Where institutional investors only hold a handful of shares in a company, they will have a low incentive to monitor the management as they can quickly liquidate their portfolio when the firm performance deteriorates. However, if their holding stakes are high and such shares are less marketable, institutional investors will hold such shares for a long period hence raising their incentive to monitor the firm's management. The extent to which institutional investors will collectively act as principals solely depend on their ability to undertake the coordination function in a cost effective manner. If coordination costs far outweigh the benefits of owning shares in a firm, then the threat of their intervention will not credible (Maug, 1998).

High institutional ownership does not necessarily foster firm performance for they may provide insignificant monitoring to the firm's management due to their own internal agency conflicts (Gorton & Kahl 1999). Denis and Denis, (1995), find that top management turnover is likely to be high in the presence of high ownership by financial institutions which may negatively impact on firm performance. These findings are in line with those of Htay, (2012) and Mohammad and Shahid, (2012) who find a negative relationship between institutional ownership and performance of banks. However, Enobakhare, (2010) finds no relationship between institutional ownership and banks performance.

### 2.3.3 Board Independence

Board independence is one of the highly debated issues in corporate governance studies due to its ability to influence board deliberations and ability to control top management decisions and company results. It is argued that independent directors are more likely to act in shareholders' interest in a better way compared to insider directors; for they do not have an incentive to collude with internal managers to expropriate shareholders wealth

(Monks & Nell, 2004). We conjecture that a more independent and effective board of directors will increase the quality and quantity of information provided by insiders to the public and therefore help reduce adverse selection costs considered by the pecking order theory. Based on a wide range of positive findings on the relationship between board independence and firm performance CBK recommends that non-executive directors should not be less than 3/5 of board size in order to enhance accountability in the banking sector (CBK, 2013).

Agency theory recommends the need to involve independent directors in the company's board to monitor any self-interested actions by managers with a view of minimizing agency costs (Williams *et al*. 2006). In actual corporate scene, internal directors are normally known to be aligned with the CEO who is the highest ranking company executive with powers to appoint executives. The directors dully appointed by the CEO may not effectively monitor the CEO. Byrd and Hickman (1992) argue that a high caliber CEO may appoint independent directors to please shareholders with an illusion that there is active monitoring in the company's activities when indeed there is none. Using work in social psychology, it is argued that humans have innate predisposition to obey authority and therefore do always act in an optimal way even though they do not personally gain by supporting an errant CEO (Morck, 2007). When the company's performance deteriorates significantly, independent board of directors are more likely to opt for a clean slate by hiring replacement of the CEO from outside than promote an internal candidate (Borokhovich *et al.* 1996). Poudel and Hovey, (2012), Al-Manaseer *et al.* (2012), Al-Hawary, (2012), Mohammad and Shahid, (2012), Al Manaseer, (2012), Nyarige, (2012), Kutubi, (2011), Trabelsi, (2010), Oyoga, (2010), Bino and Tomar, (2007), Selvam *et al.* (2006) and Sierra *et al.* (2006), all agree in their findings that there is a positive relationship between the high presence of independent directors in the bank's board with their performance.

Although agency theory recommends involvement of independent non-executive directors to promote independence of the board from management, it has been observed that independent directors rarely blow the whistle on mismanagements perpetrated by executives on the companies' assets that lead to negative performance (Morck, 2007). In the study of banks Htay, (2012), Uwuigbe, (2011) and Coleman and Biekpe, (2006) all agree that, there is a negative relationship between presence of independent directors in banks boards and their performance. It is widely acknowledged that insider directors have insider knowledge about the organization that may not be available to outside directors. They actively participate in the firm's decision making processes and hence have access to vital information that can be used to improve firm performance. However, internal directors can misuse this knowledge and information even in presence of independent directors by transferring stockholders wealth to themselves (Beasley, 1996). At the same time, all the questions regarding the firm's operation during board meetings are directed to internal directors who are required to provide detailed explanations (Anderson & Reeb 2004). Internal directors also play the role of monitoring the company's CEO by providing relevant information to independent directors if there are proves to the effect that the CEO has entrenched himself in the organization. This helps in alleviation of information asymmetry problems. It can be argued whether independent directors are indeed truly independent as they have hidden financial and personal ties with the CEO (Morck, 2007). In banking firms, the proportion of outsiders may overstate the board's true independence if there are undisclosed lending relationships with directors or the directors' employers especially where such relationships may be large enough to matter for independence (Adam & Mehran; 2005 & 2008),

Although independent directors help a great deal in decision making in companies, research has not found any direct link between board independence and firm performance. Two reasons have been advanced for this: board independence in itself is affected by financial performance; for companies react to bad performance by adding outside directors to the board and the advantages of an active independent board are normally realized when specific issues such as: CEO replacement or acquisition proposals are to be voted on. Though it is a requirement amongst most companies that majority of their directors be independent, the major weaknesses manifested by available research on the impact of independent directors on firm performance point to the fact that the degree of independence is unobservable since the choice of directors is endogenous. Cole *et al.* (2008) attributes the missing link between board independence and performance to board ineffectiveness. Despite mixed findings on the effect of outside directors on firm performance agency theory perspective has been adopted to evaluate the impact of board independence on firm performance (Pankaj *et al.* 2012). Pi and Timme, (1993), Adam and Mehran, (2005), Love and Rachinsky, (2007), Adam and Mehran, (2008), Ermina and Maria, (2010) and Romano *et al.* (2012) find no relationship between the presences of independent directors in the bank's board with their performance.

### 2.3.4 Board Size

Board size refers to the total number of directors that sits on the company's board. Board size has been a subject of significant research in terms of its relationship with firm performance, having been fuelled by prominent business failures of large companies such as Enron, WorldCom and Parmalat (Morten *et. al* 2006). It is argued that within a certain range, the larger the board, the more effective it is in its statutory duties of monitoring the management (Sanda *et al.* 2011). While there may be no one size-fits-all recommendation for what constitutes an optimal board size, a board size of 8-10 is often

recommended Yermack, (1996) while Sanda (2005) is consistent with recommendation of a company board size of ten directors including the chairman.

In theory, the board of directors is one of the most important governance mechanisms that ensure that the management of a company pursues interests that are in tandem with those of the shareholders (Allen & Gale, 2000). Its task is to monitor, discipline and remove ineffective management teams (Beiner *et al.* 2003). Spencer Stuart Board Index (2008), reports that worldwide board size has been shrinking over the years and that there is a continued trend towards smaller boards. Hermalin and Weisbach (2001) note that if boards were just to satisfy regulatory requirements, they 'would represent very high costs to firms hence the need to observe a minimum board size. In practice however, boards have been known to be generally larger than what the law requires, bringing up a more plausible hypothesis that boards are endogenously determined institutions that helps in alleviating agency problems in large firm as part of the equilibrium solution to the contracting problem between dispersed shareholders and the management (Beiner *et al.* 2003).

There are mixed findings on how board size impacts on firm performance. On one hand, it is argued according to the resource dependency theory that; board of directors with their high level links with the external environment are expected to play an important role of establishing relationships that can enable the firm access information that can be used to its advantage. Therefore, a bigger board having representation of people with diverse backgrounds and from different companies is expected to bring diversified knowledge and expertise to the board and the firm (Dalton & Daily, 1999). Ashenafi *et al.* (2013), Htay, (2012), Mohammad and Shahid, (2012), Fung, (2009), Adams and Mehran, (2008), Coleman and Biekpe, (2006), Adams and Mehran, (2005), Guo Rong *et al.* (2012) and Poulde and Hovey (2012), all agree in their studies that there is a positive relationship between board size and bank performance. Berger *et al.* (1997) finds that

firms with larger board sizes generally have low gearing levels though in practice larger boards are known to follow a policy of higher levels of gearing to enhance firm value especially when these are entrenched due to greater monitoring by regulatory authorities (Wen *et al.* 2002).

Given the unique operating environment in which banks operate, it is expected that bank boards be larger than boards in other sectors (CBK, 2013). The larger board size is further aggravated by their complex organizational structure and the presence of diverse committees such as: lending and credit risk committee, audit committee among others; whose composition entails presence of a board member. Cornet *et al*. (2009) find that big banks have larger boards. Given that the banking sector is different from other sectors, additional knowledge and experience provided by larger boards contributes to better bank performance (Belkhir, 2009).

However, large board size is seen as a limit on board effectiveness due to the following reasons; large boards prevent meaningful dialogue among directors and it is easier for the CEO to control and manipulate larger boards (Lipton & Lorsch, 1992). Yoshikawa and Phan, (2003), find that large boards are a creation of the CEO so as to entrench himself in the company. In order for the board to be free from the management and effective control of the CEO, the board size should be small. Hermalin and Weisbach, (2003) are in consensus with the finance literature that: large boards impair firm performance. This is in line with the findings of Jensen (1993) that as board size increases, they become less effective at monitoring management because of free-riding problems amongst directors and increased decision-making time. The ineffectiveness is further aggravated by increased ability of managers to shirk. Yermack (1996) finds that, on average, firm performance is lower for firms with larger boards in a sample of non-financial firms. These finding are supported by those of; (Al-Manaseer *et al.* 2012, Nyarige, 2012, Uwuigbe, 2011, Trabelsi, 2010, and Siera *et al.* 2006). De Andres and

Vallelado, (2008), who find an inverted U-shaped relationship between bank performance and board size and further find that inclusion of more directors to the company's board should: benefit the monitoring and advisory functions, improve governance, and raise returns but with a limit of 19 directors. However, Al- Hawary, (2012) Romano *et al*. (2012), Ermina and Maria, (2010), Agoraki *et al*. (2009), Love and Rachinsky, (2007), and Bino and Tomar, (2005), find no relationship between board size with bank performance.

It is only Adams and Mehran, (2005 and 2008) who find that banking firms with larger boards do not under perform their peers in terms of Tobin's q and that limiting the board size in the banking sector may be counterproductive. This is because non-executives perform an important role and are central to effective resolution of agency problems between managers and shareholders in these kinds of firms. Among other responsibilities, non-executives should critically assess, approve and review the financial and operational decisions of executive management (Fama & Jensen, 1983).

There are two main issues that complicate empirical work on boards of directors as they relate to performance of the firm. In the first place, both board size and firm performance are endogenous making econometrician face the problem of joint endogenity. This turns out to be a plausible alternative hypothesis in accordance to the findings of Jensen (1993) and Lipton and Lorsch (1992) that troubled firms expand their board in response to poor past performance in order to increase managerial capacity. The firm's performance is as a results of the actions of previous managers and itself; a factor that influences the choice of subsequent directors. This makes it difficult to determine exactly the causality effect of board size on firm performance, calling for caution when interpreting results. In the second place, many empirical results can be interpreted as either equilibrium or out-of-equilibrium phenomena. According to Hermalin and Weisbach (2001) negative relationship between board size and firm performance implies

that firms should be encouraged to limit their board size though equilibrium interpretation of this result is that some other factor is causing both board size and firm performance making any correlation between the two variables purely spurious.

### 2.3.5 Bank Size

Empirical results on the impact of bank size on performance yield mixed findings. A positive relationship is expected from this relationship because large banks are able to develop financial, human and technical capacities that can enhance efficiency and foster performance. From the wider asset base it can be argued that commercial banks can be able to source funds at competitive rate and lend it to its customers at favorable interest rates enabling them make high returns. It is widely acknowledged that interest income contributes the major source of revenue for commercial banks in Kenya (Appendix M).

Pasiouras and Kosmidou (2007) contend that larger banks might have a wide range of products and loans diversification than smaller banks leading to improved returns and performance. Large banks normally diversify their lending and deposit portfolios by moving away from traditional deposit-taking and lending practices to more cost-effective but riskier wholesale funding and market-based activities. These moves are based on the assumptions that: large banks have higher risk tolerance that is socially optimal and the social value of the market-based bank activities in the market in which large banks operate is the same as that of traditional lending. Berger *et al*. (1987) find that small cost saving can be achieved when bank size is increased. Ayadi and Boujelbene, (2012) in their study of bank performance in Tunisia between 1995 -2005, find a significant positive relationship between bank size and return on average assets; a prove that banks enjoy economies of scale when they grow their asset base. Similar, findings are made by Sinkey and Greenawalt, (1991) that larger banks are more profitable than smaller ones.

Most studies on economies of scale focus on cost economies which relates to the bank's ability to efficiently utilize its overheads in generating favorable returns. On the onset, it is realized that the larger the bank size the greater its ability to access large funds at wholesale price and the greater the ability to control lending activities and cost of deposits. Larger banks are also known to posses the ability to reduce the cost of gathering and processing information that facilitates quick decision making that should positively be associated with good performance (Uhomoibhi, 2008; & Dietrich & Wanzenried, 2011). Prior studies have found economies of scale to be limited to relatively medium sized banks, with no evidence in large banks Mester, (1992), Clark, (1996) and Berger and Mester, (1997). However, more recent studies have found that large banks also enjoy economies of scale too. There are valid economic reasons to belief that this may have changed with time. Hughes and Mester, (2013) find that an increase in bank size by 1 percent increases costs by only 0.95 percent for both small and large banks implying that the cost of making banks even smaller would be higher.

Majority of studies on the relationship between bank size and performance point to the fact that there is an estimated U-shape average cost curve. Implying that; the costs of operation in banking firms will decrease with increase in bank size up to a certain level beyond which they start increasing, hence impacting on performance negatively. Drake and Hall (2003), Wheelock and Wilson (2009) and Feng and Serlitis (2010) all find some evidence on existence of economies of scale in banks that come along with increase in total assets (bank size) which subsequently impacts on their performance positively. Berger and Mester (1997), find that large banks show a slightly higher efficiency than small ones, when efficiency is perceived from the cost perspective though such advantages can only be translated into good performance when high levels of efficiency are manifested. But if such advantages are not well exploited, they may make the bank suffer from diseconomies of scale.

Literature on economies of scale further points to the fact that banks earn negative returns when they engage in market-based activities. However, the source of these negative returns does not arise from how banks have embraced technology in their operations but from how they utilize information and agency costs (Boot & Ratnovski, 2012; Drucker & Puri, 2005). In view of the fact that agency, coordination and dysfunction problems are more prevalent in big firms, it is expected that smaller banks should be more efficient than larger banks and should perform better. In Kenya, the negative relationship between bank size and performance arise from the presence of bureaucratic processes, and other costs related to managing large firms in line with the findings of (Stiroh & Rumble, 2006; Pasiouras & Kosmidou, 2007). Naceur, and Goaied (2010), find that bank size negatively impacts on profitability if banks operate above their optimum level. Isik and Hassan (2002) in a study of Turkish banks find a strong negative relationship between bank size and efficiency which may negatively impact on the performance of these banks. Allen and Rai (1996) find that the largest banks have been marked by higher levels of inefficiency for the majority of the 15 countries they have studied.

### 2.3.6 Performance Measures

Firm performance is based on the value of the firm. The firm's corporate governance is known to improve firm performance and value because it reduces the level of expropriation of the company's assets by the management and it also improves the level of expected cash flows that can be distributed to shareholders in form of dividends. In order to evaluate firm's performance it is necessary to determine the constituents of good performance that are measurable and that are relevant to the organization in question. There is no consensus in literature on reliable performance measures in studies on corporate governance (Jong *et al*. 2002). However, much of the existing literature has used accounting based measures such as ROE and ROA and market based measures

such as Tobin's q (Heentigala & Armstrong, 2011). The use of return on asset (ROA), return on equity (ROE) and Tobin's q as performance measures are in line with the argument that use of only accounting or market measures of performance are responsible for inconsistencies in establishing a clear relationship between corporate governance and performance of firms (Bocean & Barbu, 2005).

Use of return on asset ratio shows the amount of earnings that have been generated from invested capital assets (Epps & Cereola, 2008). Return on assets allows users to assess how well firms' corporate governance mechanisms are assisting it in securing and monitoring the efficiency of the management in utilizing assets to generate profits (Mohamad, *et al.* 2011). From the bank's perspective return on asset is a percentage (%), which measures the net income earned on assets;

$$\text{ROA} = \frac{\text{Profit before tax}}{\text{Total assets}}$$

Return on asset as a performance measure is appropriate, if one considers investment in banks to include current liabilities, and owners' equity, which constitute total sources of funds invested in assets. Return on asset becomes a useful measure when one wants to evaluate how well the bank has used its funds (short-term creditors, long-term creditors, bondholders, and shareholders) in generating profits. Return on asset ratio can also be used by the bank's top management and the regulator to evaluate the performance of individual managers and commercial banks respectively in generating profits. This is in line with the profit maximization hypotheses which stipulate that: profits are indispensable for the firm's survival, to achieve other objectives will depend on the firm's ability to generate profits and profit maximization by firms has greater predicting powers on its ability to compete and expand its scale of production.

ROE measures the bank's profitability by revealing how much profit the bank generates with the money common stock holders have invested in it (Vintila & Gherghina, 2012).

$$\text{ROE} = \frac{\text{Net income (Profit after tax)}}{\text{Shareholders' equity}}$$

Where:

-Net income is for the fiscal year before dividends paid to common stock holders but after payment of dividends to preferred stock.

- Shareholder's equity does not include preferred shares.

Return on equity is useful for comparing the profitability of the bank to that of other players in the industry. It offers a useful signal of the financial success of the bank since it can indicate whether the bank is growing profits without necessarily pouring new equity capital into the business. A steadily increasing return on equity is a hint that the management is giving shareholders more for their money, which is represented by shareholders' equity. Return on equity is, in effect, a speed limit on the bank's growth rate. That is why money managers rely on it to gauge the growth potential of the bank. For high growth companies higher return on equity are expected. By averaging return on equity over the past 5 to 10 years one is able to provide a better idea of the historical growth of the firm.

Tobin's q ratio was first introduced in 1969 by James Tobin as a predictor of firm's profitable investment. Tobin's q is the bank's market value to its replacement cost. This ratio should always be greater than one to indicate that the management has done well in their investment decisions. The advantage of Tobin's q is underlined in the fact that the difficult problems encountered in estimating either rate of return or marginal costs is avoided. Dogan and Yildiz (2013) contend that Tobin's q ratio is considered to be

generally accepted measure of performance in many studies of corporate governance. Tobin's q is typically calculated in two ways: the first one being the computational costly approach that uses extensive financial statement information. The approach that was adopted in this study in computation of Tobin's q for unquoted commercial banks where:

$$\text{Tobin's q (TBQ)} = \frac{\text{Estimated Market value of Equity for unquoted banks}}{\text{Net worth of the bank}}$$

$$\text{Where Estimated market value of equity of unquoted bank} = \text{Current price of quoted bank} \times \frac{\text{Own funds (of unquoted bank)}}{\text{Own funds (of quoted bank)}}$$

The second approach uses comparatively small set of financial statements data with minimal adjustments. The advantage with this approach is that it uses a simple formula that requires financial and accounting information that is available in company's annual financial reports and the security exchange hand books. This method was adopted in computation of Tobin's q for quoted commercial banks in this study.

$$\text{Tobin's q} = \frac{\text{Market value of Equity}}{\text{Net worth of the bank}}$$

Appendix I provide performance measures for individual commercial banks in Kenya for the period of study 2001-2013.

## 2.4 Empirical Review

Al- Manaseer *et al.* (2012) empirically investigated the impact of corporate governance on performance using 15 Jordanian banks listed on Amman Stock Exchange for the period 2007 to 2009 with a total of 45 bank-year observations. The study employed pooled data, and OLS estimation method with panel data methodology. Return on asset, return on equity, profit margin and earnings per share were adopted as performance

measures (dependent variables) whereas board size, board independence, CEO status, foreign ownership and bank size were adopted as independent variables. The study revealed a significant negative relationship between board size and banks performance as measured by return on equity and earnings per share; but insignificant negative association of board size with return on asset and profit margin. It is only bank size that was significant and positively related to earning per share. The study also revealed a positive association between board independence and foreign ownership and bank performance measures (ROA, ROE, PM and EPS). In addition, CEO status had a negative significant influence on profit margin.

Ashenafi *et al.* (2013) examined corporate governance mechanisms and their impact on performance of commercial banks in absence of an organized stock exchange in Ethiopia. The study assessed the relationship between selected internal corporate governance mechanisms (board of directors' structure, board size, audit existence, bank size, and ownership type) and external corporate governance mechanism (government regulation and supervision, capital adequacy ratio, loan loss provision allowance) that were adopted as independent variables. ROA and ROE (dependent variables) were adopted as performance measures. Data on commercial banks performance was collected from annual audited financial statements for the period 2005 to 2011 that were at the National Bank of Ethiopia whereas data on board characteristic was obtained from individual banks. The study was undertaken on nine commercial banks of which two were state owned and seven were privately owned. Data was analyzed using both qualitative and quantitative methods. The findings of the study indicated that: board size and existence of audit committee in the board had statistically significant positive effect on bank performance (ROA and ROE). Similarly, capital adequacy ratio as a proxy of external corporate governance had statistically significant positive effect on bank performance (ROA and ROE) and absence of organized stock exchange, high government intervention, lack of corporate governance awareness, absence of national

standards of corporate governance, absence of accounting and auditing and weak legal framework to protect shareholder rights adversely impacted on corporate governance and bank performance in Ethiopia.

Kiruri, (2013) sought to investigate the effects of ownership structure on bank profitability in Kenya. Primary data was obtained through questionnaire administration. The study used annual reports that were available from commercial banks websites and Central bank of Kenya website. Commercial banks profits were adopted as a dependent variable, whereas ownership concentration, state ownership, foreign ownership and domestic ownership were adopted as independent variables. The findings of the study indicated that ownership concentration and state ownership had negative and significant effects on bank profitability while foreign ownership and domestic ownership had positive and significant effects on bank profitability. The study concluded that higher ownership concentration and state ownership lead to lower profitability in commercial banks while higher foreign and domestic ownership lead to higher profitability in commercial banks.

Nyarige, (2012), sought to analyze how corporate governance structures of commercial banks in Kenya affect their financial performance. The focus of the study was on the nine commercial banks listed on NSE between 2005 and 2010. Board size, board meetings, board independence and executive compensation were adopted as independent variables while Tobin q ratio was adopted as proxy for financial performance (dependent variable). The research was conducted using a Cross-sectional survey that sought to identify differences in corporate governance's structures between listed banks facing a decline in values, those facing appreciating values and those with stable value on calendar years 2005 to 2010. The findings of the study indicated that board size negatively affects the banks' market performance while board independence affects the banks' market performance positively.

Khatab *et al.* (2011) investigated the relationship between corporate governance and firms' performance the case of twenty firms listed at Karachi Stock Exchange for the period 2005 to 2009. The study used Pooled Ordinary Least Square estimation method with panel data set that covered the five years period; data from a sample of twenty firms was collected. Tobin's q, return on asset and return on equity were adopted as performance measures (dependent variables) whereas firm size, leverage and growth were adopted as independent variables. The findings of the study indicated that leverage positively and significantly impacts on Tobin's q and return on asset and leverage positively and significantly influenced return on equity. However, growth had a negative and significant impact on return on equity while the size of firms remained insignificant.

Oyoga, (2010), examined whether the performance of financial institutions listed on the NSE is affected by the corporate governance practices they have put in place. Board independence, shareholding compensation, board governance disclosure and shareholders rights were adopted as independent variables. Whereas the corporate governance index constructed as per Globe and Mail rankings using data from financial institutions and performance measures drawn from annual financial reports was adopted as a dependent variable. The findings of the study revealed that there is a positive relationship between boards composition with performance of financial institutions listed on NSE. On overall the study found that financial institutions listed on NSE should endeavor to attain the highest possible level of corporate governance.

## 2.5 Critique of Existing Literature Relevant to the Study

Quite a number of studies have been undertaken to ascertain the relationship between corporate governance and performance of banking firms in different parts of the world. However, they manifest a number of weaknesses. These are discussed as follows:

Al Manaseer *et al.* (2012), in their study on the effect of corporate governance on bank performance used earnings per share, profit margin ROA and ROE as key performance measures. However, earnings per share are not the best measure of comparative performance because different banks have different capital structures. At the same time, it is difficult to obtain the company's number of outstanding shares at a given period in time to enable one ascertain the firms EPS precisely because trading cannot be stopped. Profit margin on the other hand is derived from profitability figures of firms hence suffers from the setbacks profit as a measure of performance suffers. These include though not limited to: profit in absolute terms is not a proper guide to decision making because it leaves considerations of timing and duration undefined since there are no guidelines for comparing profit streams of different periods. This study adopted Tobin's q as a market measure of performance that Al-Manaseer *et al. (*2012) failed to adopt; in addition to ROA and ROE that represent accounting and financial measures of performance respectively as dependent variables. Institutional ownership, board independence, board size and block ownership were employed as independent variables whereas bank size was adopted as a control variable. Al-Manaseer *et al.* (2012) failed to adopt institutional ownership as an independent variable too. They adopted bank size as a proxy for corporate governance when indeed it should be adopted as a moderating variable or a control variable as was adopted in this study.

Ashenafi *et al.* (2013) in their study on corporate governance and impact on bank performance in Ethiopia provide findings that are contradictory. In the first place they found that; the existence of audit committees in banks boards had statistically significant positive effect on banks performance whereas, the absence of national corporate governance, accounting and auditing standards had adverse impact on corporate governance and bank performance. They failed to understand that in absence of national standards on corporate governance, auditing and accounting standards, banks in Ethiopia could have relied on international auditing and accounting standards as well as

international corporate governance standards as provided by the OECD and the Basel committee on banking and supervision. This might have led to presence of strong audit committees and existence of a strong external corporate governance mechanism. And the presence of a weak legal framework to protect shareholders rights in these banks might have prompted the government to frequently intervene in banks' operations. Upon adopting internationally accepted standards, heavy reliance on local standards may not be worthwhile since most banks are striving to adhere to internationally accepted practices. Whereas Ashenafi *et al.*(2013) utilized internal corporate governance mechanisms namely: board structure, bank size, audit existence, board size and ownership size and external corporate governance mechanisms namely: government regulation and supervision, capital adequacy ratio and loan loss provisioning as independent variables and ROE and ROA as dependent variables, they failed to consider Tobin's q as a market measure of performance that is critical in any study on corporate governance as per the findings of Bocean and Barbu, (2005) that this study adopted. On the same note, they shouldn't have adopted bank size as a corporate governance variable but as either a control variable or moderating variable. This is because, the ability of the bank to acquire a big size to a great extend depends on the resources at its disposal. Inadequacy of resources leading to small size does not imply bad governance given that there are small banks that outperform large banks based on the governance measures they have put in place. Therefore, bank size was employed as a control variable in this study but not as a proxy of corporate governance.

Kiruri, (2013) in his study used profitability as a measure of performance. However, use of profit as a measure of performance suffers from the following limitations; profit in absolute terms is not a proper guide to decision making for it leaves considerations of timing and duration undefined. These setbacks definitely had some effects on the findings. This study employed ROA, ROE and Tobin's q as performance measures that represented accounting, finance and marketing performance measures respectively that

Kiruri, (2013) failed to use. This study also adopted institutional ownership in addition to ownership concentration as proxies of corporate governance and bank size as a control variable that Kiruri, (2013) failed to adopt.

Nyarige, (2012) adopted Tobin's q as proxy for financial performance though it is widely acknowledged that Tobin's q is a market measure of performance. The findings of the study were that board size negatively affects firms' market performance while board independence affects market performance positively. Given that the performance measure adopted is not a financial measure of performance; no findings with respect to the effect of corporate governance structure on financial performance of commercial banks in Kenya were made. Hence the specific objective of the study was not achieved. However, this study adopted ROE and ROA in addition to Tobin's q as measures of performance, that Nyarige, (2012) had used but it rightly defined them as: market, financial and accounting measures of performance respectively that were dependent variables and institutional ownership, block ownership, board size and board independence were adopted as independent variables while controlling for bank specific characteristics using bank size.

Khatab, *et al.* (2011) in their study on corporate governance and firm performance a case study of listed firms at Karachi stock market failed to use board independence, board size, institutional ownership, block ownership as independent variables and bank size as a control variable that this study adopted. However, they adopted: ROA, ROE and Tobin's q (dependent variables) as measures of performance that this study adopted. In analyzing their data they used pooled OLS regression which is generally used when one is trying to look for the impact of change between two periods though the study was not an impact analysis. This study adopted hierarchical multiple regressions under the panel data framework for the purpose of analysis that suits studies of this nature where the effect of bank size as a control variable was precisely ascertained.

Oyoga, (2010) in a study of corporate governance and firm performance of financial institutions listed at the NSE adopted a corporate governance index constructed from Global and Mail ranking as a dependent variable. However the presence of fewer listed firms at the NSE compared to those in established stock markets and the fact that NSE manifests weak form efficiency, made the use of this corporate governance index place very high thresholds on these financial institutions. It could have been on this basis that it became precisely hard for Oyoga (2010) to explain whether the performance of these financial institutions was affected by the corporate governance practices in place. However, this study adopted Tobin's q, ROA and ROE as key performance measures that are widely used in corporate governance studies in accordance with the findings of Heentigala and Armstrong, (2007) instead of the Global and Mail ranking index that Oyoga, (2010) had used.

## 2.6 Research Gaps

While there have been numerous studies on corporate governance in the Kenyan banking sector, little has been written about the relationship between corporate governance and their performance. The findings from a few available studies are inconclusive or contradictory in nature. One reason that might have led to such inconclusiveness or contradictions is that most of the studies consider this relationship in most cases using two variables at a time while omitting other factors and interactions that may be important within the governance and performance framework of these institutions (Uwuigbe, 2012). However, this study, sought to analyze the relationship between corporate governance and performance of commercial banks in Kenya for the entire period within which the three prudential guidelines on corporate governance for institutions licensed under the Banking Act Cap 488 were issued by CBK (2001 to 2013). The study contributed to the existing literature on governance-performance linkage in banks using three performance measures namely: ROA, ROE and Tobin's q ratio that defined: accounting, finance and marketing measures of performance

respectively as dependent variables to ascertain what constitutes the best measure of performance in the study on corporate governance as it relates to commercial banks performance in Kenya a research gap the study entailed to bridge. The proxies of corporate governance were defined by four independent variables that were classified in two broad categories namely: internal corporate governance mechanisms (board size and board independence) and ownership monitoring mechanisms (block ownership and institutional ownership). Bank size was used as control variable. No one study in Kenya had supposedly used all these variables at ago. A research gap in literature that the study sought to bridge as far as industry-wide study on the relationship between corporate governance and performance of commercial banks in Kenya is concerned too.

**2.7 Summary**

It is widely acknowledged that corporate governance is a critical factor in firm performance (Weisbach, 1988, Byrd and Hickman, 1992 and Brickley *et al*. 1994). Good corporate governance practices can be considered as a compliment to risk management and control processes particularly in absence of quantitative approaches of risk measurement and hence improve firm performance (Beltratti & Stulz 2010). Accountability and transparency component of corporate governance would help commercial banks in Kenya gain shareholders' and investors' confidence to the effect that these banks are run honestly and cleverly. This is where corporate governance is critical (Morck & Steier, 2005). Hence good corporate governance would aid sustainability of Kenya's commercial banks business in the long run.

Inspite of the above, governance issues in developed countries and developing countries can vary due to the cultural, political and economic differences among individual countries though there is a wide range of interaction. Literature has confirmed that even with corporate governance mechanisms in place, there have been breaches in regulation. Hence, it is vital that a rounded recognition be driven across the corporate world that

would bring about a different perspective towards corporate governance that would foster performance especially in the Kenyan banking sector.

In line with the findings of Coleman, (2007) and Jensen and Meckling, (1976) agency theory has an effect on various corporate governance proxies and subsequent firm performance. However, due to the scarcity of relevant studies on the subject matter, contradictions in findings and bank failures that have been witnessed in Kenya, the study sought to ascertain the relationship between corporate governance and performance of commercial banks in Kenya and ascertain what constitutes the best measure of performance as it relates to the studies on corporate governance in the Kenyan banking sector. Some major findings in studies on the relationship between corporate governance and performance of banks in different parts of the world are summarized in Appendix C.

# CHAPTER THREE
# RESEARCH METHODOLOGY

## 3.1 Introduction

This chapter discusses the methods and procedures that were employed in carrying out the research. It discusses the research design, study population, research instruments, data collection procedure, pilot testing data analysis and presentation.

## 3.2 Research Design

Research design is a comprehensive plan of sequence of operations that a researcher intends to carry out to achieve the objectives of a research study (Srivastava & Rego, 2011). This study adopted descriptive research design in analyzing the relationship between corporate governance and performance of commercial banks in Kenya for the period spanning 2001-2013. Descriptive research is often used as a pre-cursor to more quantitative research designs with the general overview giving some valuable pointers as to what variables are worth testing quantitatively (Adams *et al*. 2007). To achieve the general objective of the study a survey was conducted on 43 commercial banks that were operating in Kenya during the period. Surveys are useful because they can enable the researcher get a lot of data that is accurate and cost effective in a relatively short space of time. The anonymity of surveys allows respondents to provide responses that are more candid and valid especially if it is clearly stated that the responses will remain completely confidential. Given the sensitivity of the data provided, and the need to ensure confidentiality and anonymity of the respondents, the use of survey approach sufficed as the most appropriate and suitable technique for this study.

## 3.3 Study Population

A research population is generally a large collection of individuals or objects that is the main focus of the study known to have similar characteristics or traits for whose benefit

the researches are done (Mugenda & Mugenda, 2003). 43 Senior Managers in charge of corporate affairs at each banks headquarters in whose absence the company secretary were a well-defined group of individuals that were considered as a population For the purpose of this study, a survey was conducted on the 43 commercial banks that were licensed and operating in Kenya as at 31, December 2013 as per Appendix B.

### 3.4 Research Instruments

Research instruments are testing devices used for measuring a given phenomena designed to obtain data on a topic of interest from research subject (Maina, 2012). Structured questionnaires were used as a primary data collection instrument in collecting general information on corporate governance variables that had not been captured in annual financial reports. Alongside the questionnaire was secondary data that was collected from annual audited financial reports of individual banks, commercial banks website and Central bank of Kenya website. Structured questionnaires had some control or guidance given for answers. They were of basically short and of closed form requiring the respondent to provide a 'yes' or 'no' response, or to tick an appropriate response based on likert continuum scale of the range of 1 to 5; where 1 was strongly agree, 2 agree, 3 neither agree nor disagree, 4 disagree and 5 strongly disagree.

### 3.5 Data Collection Procedure

Secondary data was collected from audited annual financial reports for individual banks found on the banks website, at the Registrar of Companies office at the Attorney General Chambers Nairobi, Nairobi Securities Exchange library and at the Central Bank of Kenya website and library. Primary data was collected using a questionnaire (Appendix A). The questionnaire was administered to members of top management of individual banks (Senior Manager in charge of Corporate Affairs in whose absence the Company Secretary). This was in line with the advocacy of the Basel Committee on Banking and

Supervision that governance structure should be composed of board of directors and Senior Management (Al-Manaseer *et al.* 2012).

Annual audited financial reports were used in the study due to ease of availability and the fact that they are reliable. The law requires all banks to file their annual financial reports with Central Bank of Kenya and the Registrar of Companies at the Attorney General Chambers, and above all have them published on or before 31st, March, of every year. For listed banks, the law further requires them to file their financial reports with the Capital Market Authority and the Nairobi Securities Exchange. Data on bank ownership was also collected from Bankscope; an on-line data source for about 29,000 banks world-wide. The questionnaire was hand dropped by the researcher to the respondents and subsequently handpicked after an agreed upon period. Both secondary and primary data collected were presented in tabular forms.

### 3.6 Pilot Testing

Pilot testing means carrying out a small scale trial run of the investigation before the commencement of the proper survey. Pilot testing enables the researcher ascertain the effectiveness of the questionnaire instrument, make sure that everyone in the survey not only understands the questions but understands them in the same way (Hoyle & Ingram, 1991). The researcher conducted a pilot study on one bank that was picked through random sampling before the main data collection exercise commenced where the questionnaire was administered to the Senior Manager in charge of Corporate Affairs. The rule of the thumb that 1% of the respondents should be picked for a pilot study was applied (Nachmias & Nachmias 2008; Sekaran & Bougie, 2009). The contents of the questionnaire were thoroughly discussed with the respondent whom the pilot study was carried on with a view of identifying any shortfall in the instrument. Issues raised with respect to measurement were adjusted without changing the meaning. However, the pilot study sample was not allowed to participate in the main study. This is because it may

influence the later behavior of research subjects if they have already been involved in the research (Haralambos, & Holborn, 2000).

### 3.6.1 Validity of Instruments

Validity is the degree by which the sample of the test items represents the content the test is designed to measure (Kothari, 2004). Validation as a process involves collecting and analyzing data to assess the accuracy of an instrument. There were several statistical tests and measures that were used to assess the validity of quantitative instruments, which generally involved pilot testing and reliability test. External validity was used in measuring the extent to which the results of a study were to be generalized from a sample to a population of items under study. Content validity was used in ascertaining the appropriateness of the contents in the research instrument that is: whether the measures (questions, observation) accurately assessed what the researchers wanted to know. Therefore the study questionnaire was scrutinized for external validity and content validity. Factor analysis was employed to test the suitability of the questionnaire especially where a variable was found to have many potentially observed constructs. Factor analysis is a statistical method used in describing the variability among observed, correlated variables in terms of a potentially lower number of unobserved constructs called factors. Factor analysis searches for such joint variations in response to unobserved latent variables.

### 3.6.2 Reliability Analysis

The reliability of the questionnaire was evaluated using Cronbach's alpha; a measure of the internal consistency of the questionnaire instrument. The value of the Cronbach's alpha coefficient ranges between 0-1.The Alpha Cronbach's formula is as given:

$$\alpha = \frac{n}{n-1}\left(1-\frac{\sum V_i}{V_{test}}\right)$$

Where α - Cronbach's Alpha.

n - The test lets (number of items to be tested).

$V_i$ - Variance of observed total test scores.

$V_{test}$ –Total variance of overall scores on the entire test (not % scores)

A higher alpha value shows a higher level of reliability. According to Coopers and Schindler, (2008), an alpha value of 0.7 and above is an acceptable reliability coefficient. Since secondary data was drawn from the published annual financial reports of banks , they were presumed to be reliable.

### 3.6.3 Data Processing and Analysis

The data collected was analyzed using: descriptive and inferential statistics. Descriptive statistics is a technique used in presenting and organizing data these include: tabulation, diagrams, graphs and certain numerical procedures all which aim at summarizing the material in a form which display its distinctive features that aid analysis. Descriptive statistics were used to quantitatively describe the important features of the variables using: frequency, mean, maximum, minimum and standard deviation. Inferential statistics on the other hand is a branch of statistics largely concerned with the analysis and interpretation of data obtained from the sample or population (Hoyle & Ingram, 1991). The questionnaire response was basically based on short closed ended questions requiring a yes or no answer responses or responses on the likert continuum scale of the range of 1 to 5. Where 1 was strongly agree, 2 agree, 3 neither agree nor disagree, 4 disagree and 5 strongly disagree. Factor analysis was used in describing the variability among observed correlated variables in terms of a potentially lower number of unobserved constructs in the questionnaire.

Under inferential statistics partial correlation analysis and hierarchical multiple regression analysis under the panel data framework were used in testing the hypotheses. Panel data analysis is a method of studying a particular subject within multiple sites,

periodically observed over a defined time frame. Westham, (2009), contends that panel data relates to repeated observations on the same cross section, typically of individual variables observed for several time periods. The characteristic this study met. Partial correlation analysis was used in identifying the nature of the relationship between the dependent and independent variables taking into consideration the effect of the control variable (bank size). The correlation coefficients were used in measuring the effect of corporate governance variables on performance: values of $\pm$ .1 represents a small effect, $\pm$.3 is a medium effect and $\pm$.5 is a large effect (Field, 2009). A correlation simply indicates that there is a weak, moderate, or strong relationship (either positive or negative), or no relationship, between two variables (Sherri, 2009). While one needs to report on statistical significance, one should focus on the strength of the relationship and the amount of shared variance.

Hierarchical multiple regression analysis was used in determining the relationship between corporate governance variables and performance variables while controlling for bank size. The study also measured the goodness to fit the regression model for return on asset , return on equity and Tobin's q ratio using $R^2$ values from which the change in $R^2$ values were derived. $R^2$ represents the proportion of variations of dependent variables accounted for by independent variables in the regression model. Whereas, change in $R^2$ is contribution to the explanation of the variance accounted for by independent variables in the regression model after introduction of the control variable. The research also observed t- statistic and significant P-value. The use of inferential statistic enabled the researcher make inferences or judgment about a population under study.

### 3.6.4 Model Specification and Variable Definition

The researcher employed a hierarchical multiple regression model of analysis under the panel data framework that is as follows:

Performance (Y) $=\beta_o+\beta_1 X_{1it}+\beta_2 X_{2it}+\beta_3 X_{3it}+\beta_4 X_{4it}$

Performance (Y) $=\beta_o+\beta_1 X_{1it}+\beta_2 X_{2it}+\beta_3 X_{3it}+\beta_4 X_{4it}+\beta_5 X_{5it}+\varepsilon_{it}$

Where:

Y -Is bank performance measured by Return on assets, Return on equity and Tobin's q ratio.

Subscripts *i* and *t* represent firm and time period, respectively.

$\beta_o$-The intercept of the model.

$X_1$-Proportion of block ownership.

$X_2$-Proportion of institutional ownership.

$X_3$-Board independence.

$X_4$- Board size.

$X_5$-Control variable bank size measured by log of total assets.

$\varepsilon_{it}$ -Is an error term.

The empirical model included bank size as a control variable related to bank specific characteristics. Prior studies such as Htay, (2012) and Bino and Tomar, (2007) had used these variables in examining the relationship between corporate governance and firm performance. The researcher employed one bank characteristic (bank size) as a control variable given that other characteristics were captured by the error term.

### 3.6.5 Independent Variables

Independent variables were those related to agency theory and corporate governance practices in commercial banks in Kenya namely: block ownership: computed as the total firm's outstanding shares owned by block holders - sum of the three largest stakes in the bank's equity .(Stepanova & Ivantsova, 2012), institutional ownership measured as % of shares held by institutions as disclosed in the annual financial reports, board independence measured as the number of non executive directors divided by the total number of directors, board size: measured as the logarithm of the number of board members and Bank size a control variable measured as logarithm of total banks assets.

### 3.6.7 Dependent Variables

Dependent variables constituted of three performance measures that were used in controlling for robustness namely:

Return on Asset: This is a purely an accounting-based measure computed from the bank's financial statement data. It is a measurement used to show the ability of the company to utilize assets in an efficient way to generate profits (Mohamad, *et al*. 2011).

$$\text{ROA} = \frac{\text{Profit before tax}}{\text{Total assets}}$$

Return on Equity (ROE) **is** one among the financial ratios used by stock investors in analyzing stocks. It is a measure of the rate of return on ownership interest of common stock owners (Vintila & Gherghina, 2012). It indicates how effective the management team in a company is converting the reinvested money into profits. The higher the company's ROE the more the money a company is able to generate for the same shilling amount spent.

$$\text{ROE} = \frac{\text{Net income (Profit after tax)}}{\text{Shareholders' equity}}$$

Where: - The profit before tax is as listed in the company's annual financial report.

- Shareholders equity=Total assets-Total liabilities (CBK 2001-2013 & The Banking Survey, 2013).

Tobin's q ratio (TBQ) named after the Nobel Laureate James Tobin. It is defined as the ratio of market value of equity to the net worth of the firm.

$$\text{Tobin's q (TBQ)} = \frac{\text{Market value of Equity}}{\text{Net worth of the bank}}$$

Market value of equity is the difference between the market value of the bank and value of debt. Net worth is the amount by which the bank's assets exceed liabilities. If the

calculated q ratio is greater than 1, there is a strong incentive for investment in the bank, to say, there are valuable growth opportunities for the bank. Since TBQ ratio is expressed as the bank market value to its replacement value, it decreases over time an indication of reduction in bank value.

For unquoted banks the research calculated the estimated market value of equity based on the formula below (Durant & Massaro, 2004).

$$\text{Estimated market value of equity of unquoted bank} = \text{Current price of quoted bank} \times \frac{\text{Own funds (of unquoted bank)}}{\text{Own funds (of quoted bank)}}$$

TBQ ratio is considered to be generally accepted measure of performance in many studies of corporate governance (Dogan & Yildiz, 2013).

### 3.6.8 Tests of Multicolinearity, Autocorrelation and Heteroskedasticity

Multicolinearity occurs in the data when two or more independent variables are highly correlated. From the perspective of this study this problem was solved by collecting data from the entire population. Two major methods were used in helping detect the presence of multicolinearity: tolerance test and Variance Inflation Factor (V.I.F.).

$$\text{Tolerance} = (1-R_i^2)$$

$$\text{V.I.F.}\ (X_2) = \frac{1}{(1-R_i^2)}$$

Where $R_i^2$ is coefficient of determination obtained when $X_i$ (i=1, 2, 3…..p) is regressed on all remaining independent variables in the model.

Autocorrelation problem occurs when error term observations in a regression are correlated making: the coefficient estimates unbiased, variance of coefficient estimates to increase hence suppressing the estimated standard errors given by ordinary least square. Durbin-Watson statistic test was used in testing first-order correlation in the

study. Durbin-Watson statistic should be in the range of 1.5 and 2.5 an indication that there is no concern of autocorrelation (Velnampy, 2011).

Heteroskedasticity problem arises in the data when the variance of the residuals is not constant across all observations. This may be as a result of sub-population differences, the model being not correctly specified or if there are any other intervention effects in the data or an omission of very important variables from the model. To check this problem, the researcher ensured that the model was correctly specified as contextualized in 3.7.1. This problem was checked by plotting error term observations or residuals against a Z factor. Heteroskedasticity becomes a problem when the error term observations swing further from zero as one move to the right-fan shaped patterns (Halcoussis, 2005).

# CHAPTER FOUR
# RESEARCH RESULTS AND DISCUSSION OF FINDINGS

## 4.1 Introduction

The chapter presents empirical findings and discussion of results of the relationship between corporate governance and performance of commercial banks in Kenya using variables and techniques mentioned in chapter three. Whereas data analysis has been in line with specific objectives are interpreted and implications drawn thereof. This was accomplished as presented by the findings that are discussed thereof:

## 4.2 Response Rate

A survey was conducted on 43 commercial banks operating in Kenya by way of questionnaire administration. 33 questionnaires were returned by respondents. This represented 76.7 % of the response rate; 14% of the banks did not respond at all; whereas, 9.3% of the banks were found to be structured as branches of parent foreign banks and did not have board committees; instead they had local advisory and management committees. Hence, it was not possible to ascertain the level of board independence of the local advisory committees and the board size of those banks. This rendered it difficult for the objective on board independence and board size as they relate to performance in these banks to be achieved by the researcher. In view of this, they were excluded from the study. These were: Bank of India, Citibank, Habib bank Zurich and Habib Bank Limited. Mugenda and Mugenda, (2003) recommends that: 50% response rate is adequate, 60% good and any other response rate above 70% very good. Based on these recommendations, the response rate of 77% was rated very good. Therefore the data collected was capable of enabling the researchers arrive at a satisfactory conclusion about the study.

### 4.3 Reliability Test

The responses in data collected using the questionnaires were subjected to reliability test. Cronbach's alpha coefficient was used in measuring the reliability of this data with a view of estimating the internal consistency of the questionnaire instrument that was used in data collection. Cronbach's alpha ranges between 0 and 1.00. The higher this coefficient, the more reliable is the test. Zinbarg, (2005) recommends an alpha value of 0.70 and above as an indicator that the data collected has achieved a relatively high internal consistency and can hence be generalized to be representative of the target population. Reliability test results are presented in table 4.1.

**Table 4.1: Reliability Test**

| Corporate Governance Variables | Cronbach's Alpha coefficients | Comments |
|---|---|---|
| Block ownership | 0.767 | Accepted |
| Institutional ownership | 0.704 | Accepted |
| Board Independence | 0.738 | Accepted |
| Board size | 0.735 | Accepted |
| Overall | 0.898 | Accepted |

The study reported an overall Cronbach's alpha value of 0.898 for the questionnaire instrument (Table 4.1). Independent variables reported Cronbach's alpha values of: 0.767, 0.704, 0.738 and 0.735 for: block ownership, institutional ownership, board independence and board size respectively. These values were above 0.70 thresholds as recommended by Zinbarg, (1995) implying that the data collected had achieved a relatively high level of consistency and could be generalized to be representative of the target population and could be used for further analysis. The data on bank size was gathered from the annual financial reports of the individual banks and therefore were regarded reliable.

### 4.4 Factor Analysis

On examination of variables in the questionnaire, it was found that most of the variables had between 6 and 7 constructs with factor loadings that were above 0.40; hence could be subjected to further analysis (Tabachnick & Fidell, 2007). However, board independence had 18 constructs; given the higher number of constructs, this variable was subjected to factor analysis. Factor analysis was used in exploring possible underlying factor structure of a set of observed variables under board independence without imposing a preconceived structure on the outcome.

#### 4.4.1 Testing Adequacy of sample for factor analysis

Kaiser-Meyer-Olkin (K.M.O) measure was used in testing the adequacy of the data collected on board independence for factor analysis. This measure ranges between 0 and 1. The K.M.O. values closer to 1 are considered as better values whereas values greater than .5 are considered adequate (Leech *et. al* 2005). Along with this measure, the Bartlett's Test of Sphericity was used in testing the null hypothesis that the correlation matrix had an identity matrix. The results of these two tests were used in determining the minimum standard required to proceed with factor analysis. To aid in the analysis the table 4.2 below was generated.

**Table 4.2: KMO Bartlett's Test**

| **Particulars** | | **Values** |
|---|---|---|
| Kaiser Meyer- Olkin Measure of sampling adequacy | | .596 |
| Approximate chi square | | 328.363 |
| Barletts Test of Sphericity | Df | 153 |
| Sig. | | .000 |

Normally, if $0 < KMO < 1$ and if $KMO > 0.5$, the data collected is considered adequate for factor analysis. From the results (Table 4.2), KMO was 0.596 and the Bartlett's Test of Sphericity at 95% level of confidence was significant (p-value of $.000 < 0.05$). These

results indicated that the items on board independence were adequate for factor analysis paving way for the researcher to proceed with factor analysis.

Upon running factor analysis it revealed the presence of six components with eigenvalues exceeding 1 that explained 34.298%, 2.212%, 8.521%, 7.661%, 6.609% and 6.148% of the variance (Appendix G). Implying that, six of the eighteen original constructs were retained for further analysis. This was further supported by a break after the sixth item as illustrated by the scree plot (Appendix H).

The six constructs/factors that remained after factor analysis were as identified as in table 4.3 below.

**Table 4.3: Communalities of Board independence Variables**

| Board independence factors | Initial | Extraction |
|---|---|---|
| -Whether the board is truly independent. | 1.000 | 0.798 |
| -Board has the responsibility of selecting the CEO. | 1.000 | 0.792 |
| -Board is a forum of serious discussions. | 1.000 | 0.857 |
| -Board has ability to revise key executive decisions Including remuneration. | 1.000 | 0.835 |
| -Board reviews potential conflict of interest including Related parties' transactions. | 1.000 | 0.815 |
| -Board ensures integrity of the bank's financial Reporting. | 1.000 | 0.884 |

These six constructs/factors had factor loadings of between 0.792 and 0.835 (Table 4.3). Hair *et al.* (1998) and Tabachnick & Fidell (2007) recommend a cut off factor of 0.40 on factor loadings in determining the factors to be retained for further analysis. Given that all the six constructs had factor loadings above the 0.4, they were all retained and used in further analysis. This paved way for a detailed discussion on responses on the above constructs in the subsequent sections of the study.

### 4.5 Study Variables

The study variables were analyzed based on the responses of various respondents as per (Appendix J) that are as follows:

#### 4.5.1 Block Ownership

The study sought to ascertain whether the largest shareholders in Kenyan commercial had substantial voting rights and effectively controlled the activities of the management. 84.8% of the respondents were strongly in agreement whereas 15.2% of the respondents were in disagreement over the fact that the largest shareholders had substantial voting rights and effectively controlled the activities of the management in those banks;. The respondents also indicated that between the years 2001 and 2013 over 80% of the shareholders in Kenyan commercial banks owned 35.33% of the outstanding shares whereas fewer than 20% of the shareholders owned 64.67% of the outstanding shares. As to whether commercial banks in Kenya belonged to the same group as the bank, 39.4% of the respondents strongly indicated that commercial banks in Kenya belonged to the same group as the bank, 54.5% were in agreement whereas 6.1% could neither agree nor disagree. Cumulatively 93.9% of the respondents indicated that commercial banks in Kenya belonged to the same group as the bank. The overall results from the responses from various respondents indicate that there is a high level of block holding in Kenyan commercial banks.

#### 4.5.2 Institutional Ownership

In order to understand how institutional ownership impacts on performance of commercial banks in Kenya, 45.5% of the respondents strongly indicated that institutional investors had other engagements in the bank apart from being shareholders. 33.6% were in agreement, 15.2% could neither agree nor disagree whereas 6.1% of the respondents were not in agreement. Cumulatively, 78.8% of the respondents indicated that institutional investors had other business engagements with the bank apart from

being shareholders and due to this dual interests, this may have an effect on the performance of these banks. The respondents further indicated that these institutional shareholders rarely use their vote as indicated by 78.8% of the respondents cumulatively. This could be attributed to the following: institutional owners normally disclose how they manage material conflict as indicated by 97% of the respondents cumulatively, they disclose their voting policies as indicated by 81.8% of the respondents cumulatively and they also disclose their overall corporate governance about their investments in these banks. Since all these disclosures are in the domain of commercial banks it is expected that they are at minimum required to adhere to them because institutional investors cannot move into and out of these banks without influencing the share price.

### 4.5.3 Board independence

Cumulatively 69.7% of the respondents to a very large extent indicated that independent boards of directors in their banks were truly independent while 30.3% indicated that they were not. To demonstrate how independent these directors are, 27.3% of the respondents were strongly in agreement, that independent directors in their banks are able to reverse key executive remuneration decisions, 54.5% were in agreement, 12.1 % were indifferent and 6.1% were in disagreement. Cumulatively, 81.8 % of the respondents were generally in agreement that the board revises key remuneration decisions in their banks. Regarding the role played by independent directors in selection and monitoring of the CEO; 63.6% of the respondents to a very large indicated that independent board of directors have a strong voice in selection and monitoring the CEO, 18.2% indicated to a large extent, 9.1% were indifferent or moderate, whereas 9.1% indicated that independent directors did not play any role in the selection and monitoring the CEO. Cumulatively 81.8% of the respondents indicated that independent board of directors had a role in monitoring and controlling the activities of the CEO. On whether the board

was a forum of serious discussion where major decisions that impact on performance were discussed; 66.7% of the respondents strongly indicated that the board was a forum of serious discussions where major decisions that impact on bank performance were discussed, 18.2% were merely in agreement, whereas 15.2% were indifferent. Cumulatively 84.9% of the respondents were in agreement that the board was a forum of serious discussions where major decisions that impact on commercial performance in commercial banks were discussed. The findings further demonstrated that the board ensures effectiveness of corporate governance in the Kenyan banking sector as indicated strongly by 33.3% of the respondents, 60.6% being agreement, whereas 6.1% being in disagreement. Cumulatively, 93.9% of the respondents indicated that the board ensures effectiveness of corporate governance in the banking sector. This was further affirmed by 90.9% of the respondents who were cumulatively in agreement that independent board of directors also ensured integrity in financial reporting in these banks.

### 4.5.4 Board Size

78.8% of the respondents strongly indicated that banking firms require bigger boards to cater for professional diversification in decision making, 12.1% were in agreement, 6% of the respondents could neither agree nor disagree, whereas 3% strongly disagreed with the presence of a bigger board. Cumulatively 90.9% of the respondents indicated that commercial banks require bigger boards that will enable it draw diverse professional advice from.

### 4.5.5 Bank Size

As regards to whether banks acquire a large size in order to reduce risk of failure: 30.3% of the respondents were strongly in agreement that banks acquire a large size so as to reduce the risk of failure, 27.3% were in agreement, 27.3% were indifferent, 3.0% were in disagreement whereas 12.1% were in strongly in disagreement. Cumulatively, 57.6%

of the respondents were in agreement that commercial banks in Kenya acquire a large size in order to reduce the risk of failure. As to whether commercial banks in Kenya have acquired a large size due to recent development in information technology: 21.2% of the respondents were strongly in agreement, 54.6% were in agreement, 15.2% were indifferent whereas 9.1% were in disagreement. Cumulatively 75.8% of the respondents were in agreement that commercial banks in Kenya had acquired a large size due to recent developments in information technology. On whether commercial banks in Kenya banks have acquired a large size so as to take advantages of economies of scale; 57.6% of the respondents were strongly in agreement with this whereas 42.4% were in agreement. Cumulatively, 100% of the respondents were generally in agreement that commercial banks in Kenya were acquiring a large asset base so as to reap the benefits of large scale economies.. 45.5% of the respondents were in strong agreement that commercial banks in Kenya were growing their asset base so as to attain wider customer coverage, 51.3% were in agreement, and 3.0% were indifferent. Cumulatively, 97% of the respondents indicated that commercial banks in Kenya were acquiring a large size so as to satisfy wider and growing customer base.

### 4.6 Descriptive Statistics Results

Descriptive statistics results were used in describing the basic features of data by providing simple summaries about the sample and the measures used. Tronchim, (2006) contents that; along with simple graphics analysis, descriptive analysis virtually forms the basis of every quantitative analysis of data. In this study, descriptive statistics were employed to provide: means, maximum, minimum and standard deviation of data collected on corporate governance and performance of the commercial banks in Kenya.

Table 4.4 presents descriptive statistics results on the relationship between the corporate governance mechanisms (block ownership, institutional ownership, board independence

and board size as they relate to the performance of commercial banks in Kenya (ROA,ROE and TBQ ratio as per Appendix I) taking into account the effect of bank size as a control variable.

**Table 4.4: Descriptive Statistics**

| Variables | Observations-n | Minimum | Maximum | Mean | Standard deviation |
|---|---|---|---|---|---|
| ROA | 33 | -.13 | .37 | .0257 | .03829 |
| ROE | 33 | -.67 | 1.25 | .1238 | .14974 |
| TBQ ratio | 33 | .00 | 9.13 | .9367 | 1.4224 |
| Block ownership | 33 | .59 | 1.00 | .6814 | .21685 |
| Institutional ownership | 33 | .00 | .59 | .1998 | .16402 |
| Board independence | 33 | .17 | .92 | .6747 | .13890 |
| Board size | 33 | .60 | 1.18 | .8633 | .12959 |
| Bank size | 33 | 2.88 | 5.51 | 4.1179 | .60476 |

From the data received from 33 commercial banks (Table 4.4), the findings indicate that commercial banks in Kenya had an average board size of about 8 directors (antilog. of .8633), a maximum of 16 (antilog. of 1.18) and a minimum of 4 (antilog. of .60) directors, that deviated by 1 (antilog. of .12865) director on both sides of the mean. The findings further indicated that independent directors constituted of 67.47% of the board size, with a maximum of 92% and a minimum of 17% that were spread on either side of the mean by 13.89%.

On average institutional investors held 19.98% of equity stakes in these banks, with a maximum of 59% and a minimum of 0 that were spread on either side of the mean by 16.402%. Block holders on average owned 68.14% of equity stakes with a maximum of 100% and a minimum of 59% that were spread on both sides of the mean by 21.685%.

The average size of assets in these banks (bank size) during (2001-2013) was Kshs.13, 119 million (antilog. of 4.1179), with a maximum of Kshs.323, 594 million (antilog. of 5.51) and a minimum of Kshs.759 million (antilog of 2.88) that deviated on both sides of the mean by 60.476%.

Using Return on asset as a measure of performance the findings indicate that commercial banks in Kenya reported an average return on asset of 2.57% with the maximum of 37% and minimum of -13% that deviated by 3.829% on both sides of the mean. The standard deviation was relatively low 3.829%. When return on equity was employed as a performance measure, the findings indicate that commercial banks in Kenya reported an average return on equity of 12.44% with a maximum of 125% and a minimum of -67% that deviated by 14.985% on both sides of the mean. The standard deviation of 14.985% indicated a relatively high disparity in ROE. Using Tobin's q ratio as a measure of performance, the findings indicated that commercial banks reported an average Tobin's q ratio of .9379 with the highest/ maximum of 9.13 and a minimum of zero that deviated by 1.42 on both sides of the mean.

## 4.6 Inferential Statistics Results

### 4.6.1 Correlation Analysis

Table 4.5 displays the correlation coefficient values between dependent and independent variables and between the dependent variables themselves. The examination of the correlation coefficients helps in accepting or rejecting the null hypothesis that there is no correlation between the explanatory variables. The degree of the linear relationship between two variables in correlation ranges between +1 and -1. A correlation of +1 implies that there is perfect positive linear relationship between variables hence concern of multicolinearity problem (Sekran, 2003). On overall the correlations were very low. Only block ownership and institutional ownership had a correlation coefficient of -.781. However the rest of the variables had correlation coefficients that were generally moderate (less than .445). On overall the correlation coefficients were far much less than 0.8 threshold indicating that there was no concern for multicolinearity (Kennedy, 1985).

Therefore, we fail to reject the null hypothesis that there is no correlation between the explanatory variables.

**Table 4.5: Partial Correlation Analysis**

| Control variables | ROA | ROE | TBQ ratio | Block ownership | Institutional ownership | Board independence | Board size |
|---|---|---|---|---|---|---|---|
| Bank size | 1.000 | | | | | | |
| ROA correlation | | | | | | | |
| Significance (1-tailed) | . | | | | | | |
| ROE correlation | .246 | 1.000 | | | | | |
| Significance (1-tailed) | .000* | . | | | | | |
| TBQ ratio correlation | .015 | .128 | 1.000 | | | | |
| Significance (1-tailed) | .381 | .005* | . | | | | |
| Block ownership correlation | -.017 | -.096 | -.047 | 1.000 | | | |
| Significance (1-tailed) | .369 | .026* | .171 | . | | | |
| Institutional ownership | -.007 | -.080 | -.016 | -.781 | 1.000 | | |
| Significance (1-tailed) | .445 | .049* | .376 | .000* | . | | |
| Board independence | -.055 | -.075 | -.008 | -.116 | .096 | 1.000 | |
| Significance (1-tailed) | .133 | .063** | .432 | .009* | .026* | . | |
| Board size | -.070 | -.114 | .158 | -.127 | .012 | .437 | 1.000 |
| Significance (1-tailed) | .077** | .010* | .001 | .005* | .408 | .000* | . |

* Significant at 5% one tailed level.
**significant at 10% one tailed level.

On observation of the correlation results in table 4.5, it was found that the correlation of ROA with each of the four proxies of corporate governance namely: block ownership, institutional ownership, board independence and board size was not statistically significant at 5% level (r=-.017, p-value=.369; r=.007, p-value=.445; r=-.055, p-value=

.133 and r=-.070, p-value= .077 respectively). Implying that the correlations between: each of these variables with ROA does not exist above and beyond the effects of bank size. Invariably meaning that the above corporate governance mechanisms have got no effect on the ROA of commercial banks in Kenya after controlling for the effect of bank size.

The financial measure of performance ROE was observed to have negative and statistically not significant correlation at 5% level of significant with board independence (r=-.075, p-value=.063). Implying that the correlation between board independence and ROE does not exist above and beyond the effect of bank size- hence board independence does not have any influence on commercial banks performance when ROE is adopted as a performance indicator after controlling for the effect of bank size. However, there was a negative and statistically significant correlation at 5% level of significant between block ownership and institutional ownership with ROE (-.096, p-value=.026 and -.080, p-value= .049 respectively). Meaning that, the correlation between block ownership, institutional ownership and the performance of commercial banks in terms of ROE exists above and beyond the effect of bank size. Implying that; as the level of intuitional shareholders and block holding rises in Kenyan commercial banks their performance in terms of ROE decreases after controlling for the effect of bank size.

A positive and significant correlation at 5% level of significant was observed between TBQ ratio of commercial banks with board size (r=.158, p-value=.002). Implying that, the correlation between board size with TBQ ratio exist above and beyond the effect of bank size. Invariably meaning that as the board size of commercial banks increases so does TBQ ratio increases after controlling for the effect of bank size. Negative though not statistically significant correlations at 5% level of significant were observed between block ownership (r=-.047, p-value= .171), institutional ownership (r=-.016, p-

value=.376), board independence (r=-.008, p-value=.432) each with TBQ ratio. Implying that, the correlations between institutional ownership and block ownership with TBQ ratio does not exist above and beyond the effects of bank size. Hence: high levels of block ownership, high levels of institutional ownership and board independence has no impact on the performance of commercial banks in Kenya when TBQ ratio is adopted as a performance measure after controlling for the effect of bank size.

### 4.6.2 Regression Analysis

Hierarchical multiple regression was adopted in analyzing the relationship between corporate governance and performance of commercial banks in Kenya. Performance indicators were defined by: ROA, ROE and Tobin's q ratio that were: accounting, finance and marketing measures of performance respectively, the proxies of corporate governance were: block ownership, institutional ownership, board independence and board size taking into account the effect of bank size as a control variable. The null hypothesis for the entry of the control variable to the analysis was that change in $R^2$ (contribution to the explanation of the variance in the performance variable) was zero. If the null hypothesis was to be rejected then the interpretation was to indicate that the variables in block 2 or step 2 of the model had a relationship with the dependent variable after control of block 1 or step 1 variable to the dependent variable with bank size. In a nutshell, hierarchical regression was used in examining the degree of standardized unit change in the dependent variable (performance) for every standardized unit change in the independent variable (block ownership, institutional ownership, board independence and board size) while taking into account the effect of bank size as a control variable in the model.

The support for a hierarchical regression for the overall relationship required a statistical significance for the addition of the control variable. The effect of variables entered in the

previous steps or blocks were ignored all together, whether they were statistically significant or not. This was because the analysis was interested in obtaining the best indicator of the effect of the control variable bank size. Thus the statistical significance of the previously entered variables was not interpreted. In essence, hierarchical regression analysis focuses on change in $R^2$. If change in $R^2$ is statistically significant, the overall relationship for all independent variables will be significant too.

To guide the analysis three definition models were adopted as illustrated:

**Model 1**

$Y=f(\beta_1X_{1it,}\beta_2X_{2it,}\beta_3X_{3it,,}\beta_4X_{4it})\ldots$ ..... (1)

Where Y is $ROA_{it}$.

Meaning return on asset of a bank at any given time is a function of: $\beta_1X_{1it,}$ $\beta_2X_{2it,}$ $\beta_3X_{3it,}$ and $\beta_4X_{4it.}$

$Y_{it}=\beta_o+\beta_1X_{1it}+\beta_2X_{2it}+\beta_3X_{3it}+\beta_4X_{4it}+\beta_5X_{5it}+\varepsilon_{it}$..... (2)

Where:

Subscripts *i* and *t* represent firm and time period, respectively.

$ROA_{it}$ -Is bank performance measured by Tobin's q ratio.

$\beta_o$- Intercept term

$X_1$-Proportion of block ownership.

$X_2$-Proportion of institutional ownership.

$X_3$-Board independence.

$X_4$- Board size.

$X_5$-Control variable bank size.

$\varepsilon_{it}$ - error term.

Hierarchical multiple regression analysis was undertaken to test the hypothesis that there was no relationship between the dependent variable ROA and the predictor independent variables: block ownership, institutional ownership, board independence and board size while controlling for the effect bank size. The results were as per table 4.6 below:

**Table 4.6: Regression Model Summary[c] (ROA)**

| | R | R-squared | Adjusted R-squared | R-squared change | F Change | df 1 | Df2 | Sig. F change | Durbin Watson |
|---|---|---|---|---|---|---|---|---|---|
| 1 | .165[a] | .022 | .018 | .027 | 2.876 | 4 | 410 | .023 | |
| 2 | .280[b] | .078 | .067 | .051 | 22.619 | 1 | 409 | .000 | 1.540 |

[a.] Predictors: (Constant) Block ownership, Board size, Board independence, Institutional ownership.

[b.] Predictors: (Constant) Block ownership, Board size, Board independence, Institutional ownership, Bank size.

[c.] Dependent variable: ROA.

Based on model 2 in the Model Summary table 4.6 where the predictors were added after controlling for bank size, ($F(1,409) = 22.619$; $P < .05$), the findings indicate that the predictors variable, block ownership, institutional ownership, board size and board independence, contributed to the overall relationship with the dependent variable, return on asset after controlling for bank size. The F-statistic of 22.619 with a probability ratio of .000 indicated that the overall model was significant and that all the independent variables were jointly significant in explaining the variation in the dependent variable (ROA). Therefore the null hypothesis that change in $R^2$ was equal to 0 was rejected. The research hypothesis that bank size reduced the error in predicting return on asset of commercial banks in Kenya was supported. The increase in $R^2$ by including the control variable in the analysis was .051.

Table 4.7 shows the regression results: beta coefficients (both standardized and unstandardized), standard and unstandardized errors, their t-ratios, significant or insignificant levels, tolerance and variance inflation factor when ROE was adopted as a performance measure.

**Table 4.7: Regression Results of Return on Asset[a]**

| Model | B | Unstandardized Std Error | coefficients Beta | Standardized t | Sig. | Tolerance | V.I.F. |
|---|---|---|---|---|---|---|---|
| 1 (Constant) | .023 | .020 | | .148 | .252 | | |
| Block ownership | -.016 | .014 | .093 | -1.175 | .241 | .376 | 2.659 |
| Institutional ownership | -.017 | .014 | -.096 | -1.208 | .288 | .375 | 2.668 |
| Board independence | -.027 | .015 | -.097 | -1.844 | .066 | .865 | 1.156 |
| Board size | .040 | .016 | .135 | 2.475 | .014 | .802 | 1.247 |
| 2 (Constant) | -.017 | .022 | | .786 | .432 | | |
| Block ownership | -.013 | .013 | -.077 | -.989 | .241 | .375 | 2.664 |
| Institutional ownership | -.012 | .014 | -.064 | -.818 | .414 | .372 | 2.689 |
| Board independence | -.008 | .015 | -.028 | -.519 | .604 | .801 | 1.249 |
| Board size | -.025 | .021 | -.085 | -1.204 | .229 | .457 | 2.190 |
| Bank size | .020 | .004 | .310 | 4.756 | .000 | .531 | 1.884 |

[a]Dependent variable ROA.

The overall regression equation for this model is:

$Y=-.017-.013X_1-.012X_2-.008X_3-.025X_4+.020X_5$

Based on the statistical test of the beta coefficient ($t = 4.756$, $p<0.00$) for the control variable bank size, the null hypothesis that beta coefficient was equal to 0 (zero) was rejected and the research hypothesis that bank size had an effect in the relationship between corporate governance and return on asset of commercial banks in Kenya was supported. The beta coefficient for the relationship between the dependent variable return on asset and the control variable bank size was .020 implying that there is a direct

relationship as indicated by the positive sign of the coefficient. This invariably means that higher positive numeric values for the control variable bank size are associated with higher numeric values for the dependent variable ROA (performance). Therefore the alternative hypothesis that bank size is associated with high performance of commercial banks in Kenya when ROA is used as a performance measure was upheld.

From these results only bank size was found to be statistically significant at 5% significant level, whereas board size, board independence, institutional ownership and block ownership were found not to be statistically significant at 5% significant level. This invariably means that as the asset base of commercial banks in Kenya increases ROA as a performance measure increases. But the changes in all other proxies of corporate governance do not have any effect on ROA. Bank size recorded the highest beta value ($\beta$ =.020, P< .05), than board independence ($\beta$=-.008, P>.05), board size ($\beta$ = -.025, P> .05), institutional ownership ($\beta$= -.012, P < .05) and block ownership ($\beta$=-.013, P>.05) respectively. Although the proxies of corporate governance in the model (block ownership, institutional ownership, board independence and board size were found not to be significant, the fact they had a negative beta coefficient could be assessed as an important outcome.

**Model 2**

$Y=f(\beta_1 X_{1it,}\beta_2 X_{2it,}\beta_3 X_{3it,,}\beta_4 X_{4it})$.…… (1)

Where Y is $ROE_{it}$.

Meaning return on equity of a bank at any given time is a function of: $\beta_1 X_{1it,}$ $\beta_2 X_{2it,}$ $\beta_3 X_{3it,}$ and $\beta_4 X_{4it.}$

$Y_{it}=\beta_o+\beta_1 X_{1it}+\beta_2 X_{2it}+\beta_3 X_{3it}+\beta_4 X_{4it}+\beta_5 X_{5it}+\varepsilon_{it}$..... (2)

Where:

Subscripts *i* and *t* represent firm and time period, respectively.

$ROE_{it}$ -Is bank performance measured by Return on equity.

$\beta_o$-Intercept term

$X_1$-Proportion of block ownership.

$X_2$-Proportion of institutional ownership.

$X_3$-Board independence.

$X_4$- Board size.

$X_5$-Control variable bank size.

$\varepsilon_{it}$ - error term.

Hierarchical multiple regression analysis was undertaken to test the hypothesis that there was no relationship between the dependent variable ROE and the predictor independent variables: block ownership, institutional ownership, board independence board size while controlling for the effect bank size. The results were as per table 4.8 below:

**Table 4.8: Regression Model Summary[c] (ROE)**

| Model | R | R-squared | Adjusted R-squared | R-squared change | F Change | df 1 | Df2 | Sig. F change | Durbin Watson |
|---|---|---|---|---|---|---|---|---|---|
| 1 | .303[a] | .092 | .083 | .092 | 10.3834 | 4 | 410 | .000 | |
| 2 | .458[b] | .209 | .200 | .117 | 60.690 | 1 | 409 | .000 | 1.521 |

a. Predictors: (Constant) Block ownership, Board size, Board independence, Institutional ownership.

b. Predictors: (Constant) Block ownership, Board size, Board independence, Institutional ownership, Bank size.

c. Dependent variable: ROE.

Based on model 2 in the Model Summary table 4.8 where the predictors: block ownership, institutional ownership, board size and board independence, after controlling for bank size were added ($F(1,409) = 60.690$; $P < .05$), the results indicated that these predictors contributed to the overall relationship with the dependent variable, return on equity. The F-statistic of 60.690 with a probability ratio of .000 indicated that the overall model was significant and that all the independent variables were jointly significant in explaining the variation in the dependent variable (ROE). Therefore the null hypothesis

that change in $R^2$ was equal to 0 was rejected. The research hypothesis that bank size reduced the error in predicting return on equity of commercial banks in Kenya was supported. The increase in $R^2$ after including the control variable (bank size) in the analysis was .117.

Table 4.9 shows the regression results where estimated coefficient for each variable are shown when return on equity was used as a performance measure.

**Table 4.9: Regression Results of Return on Equity[a]**

| Model | B | Unstandardised Std Error | Coefficients Beta | Standardized T | Sig. | Tolerance | V.I.F. |
|---|---|---|---|---|---|---|---|
| 1 (Constant) | .237 | | | 3.062 | .002 | | |
| Block ownership | -.209 | .052 | -.310 | -4.045 | .000 | .376 | 2.659 |
| Institutional ownership | -.222 | .055 | -.312 | -4.063 | .000 | .375 | 2.668 |
| Board independence | -.136 | ,055 | -.126 | -2,487 | .013 | .865 | 1.156 |
| Board size | .192 | .061 | .165 | 3.143 | .002 | .802 | 1.247 |
| 2 (Constant) | -.004 | .079 | | -.047 | .962 | | |
| Block ownership | -.192 | .048 | -.285 | -3.971 | .000 | .375 | 2.664 |
| Institutional ownership | -.187 | .051 | -.263 | -3.650 | .000 | .372 | 2.689 |
| Board independence | -.023 | .053 | -.021 | -.430 | .668 | .801 | 1.249 |
| Board size | -.196 | .076 | -.168 | -2.580 | .010 | .457 | 2.190 |
| Bank size | .117 | .015 | .470 | 7.790 | .000 | .531 | 1.884 |

[a]Dependent variable ROE

The overall regression model for this model was:

$Y = -.004 - .192X_1 - .187X_2 - .023X_3 - .196X_4 + .117X_5$

Based on the statistical test of the beta coefficient ($t = 7.790$, $p<0.05$) for the control variable bank size, the null hypothesis that the slope or beta coefficient was equal to 0 (zero) was rejected. The research hypothesis that there was a relationship between corporate governance and return on equity of commercial banks in Kenya and that this corporate governance mechanisms are significantly affected by bank size was supported. The beta coefficient for the relationship between the return on equity and the control

variable bank size was .117 implying that the higher the bank size the higher the ROE of commercial banks. Therefore the alternative hypothesis that high bank sizes are associated with high performance of commercial banks in Kenya in terms of ROE was upheld.

Block ownership, institutional ownership and board size were found to be statistically significant at 5% level of significant. However it is only board independence that was not statistically significant at 5% of significance. Bank size recorded a higher beta value (β= .117), institutional ownership (β= -.187, P>.05), block ownership (β=-.192, P< .05) and board size (β=-196, P<.05)- invariably meaning that: as board size, institutional ownership and block ownership increases the ROE of commercial banks in Kenya decreases. But as bank size increases the ROE of commercial banks in Kenya increases. Although board independence was found not to be significant, the fact it had a negative beta coefficient can be assessed as an important outcome.

**Model 3**

$TBQ_{it}=f(\beta_1X_{1it},\beta_2X_{2it},\beta_3X_{3it},\beta_4X_{4it}$ ..... (1)

Meaning Tobin's q of a bank at any given time is a function of: $\beta_1X_{1it}$, $\beta_2X_{2it}$, $\beta_3X_{3it}$, and $\beta_4X_{4it}$.

$TBQ_{it}=\beta_o+\beta_1X_{1it}+\beta_2X_{2it}+\beta_3X_{3it}+\beta_4X_{4it}+\beta_5X_{5it}+\varepsilon_{it}$..... (2)

Where:

$TBQ_{it}$ -Is bank performance measured by Tobin's q ratio.

Subscripts *i* and *t* represent firm and time period, respectively.

Y-$TBQ_i$

$\beta_o$- Intercept term

$X_1$-Proportion of block ownership.

$X_2$-Proportion of institutional ownership.

$X_3$-Board independence.

$X_4$- Board size.

$X_5$-Control variable bank size.

$\varepsilon_{it}$ - error term.

Hierarchical multiple regression analysis was undertaken to test the hypothesis that there was no relationship between the TBQ ratio and the predictor independent variables: block ownership, board size, board independence and institutional ownership after controlling for the effect bank size. The results were as per table 4.10 below:

**Table 4.10: Regression Model Summary[c] (TBQ ratio)**

| Model | R | R-Square | Adjusted R-Square | R Square change | F change | df1 | df2 | Sig. F change | Durbin Watson | |
|---|---|---|---|---|---|---|---|---|---|---|
| 1. | .498[a] | .248 | .240 | .248 | 33.714 | 4 | 410 | .000 | | |
| 2. | .584[b] | .341 | .333 | .094 | 58.063 | 1 | 409 | .000 | 1.664 | |

[a.] Predictors: (Constant) Block ownership, Board size, Board independence, Institutional ownership.

[b.] Predictors: (Constant) Block ownership, Board size, Board independence, Institutional ownership, Bank size.

[c.] Dependent variable: TBQ ratio.

Based on model 2 (step 2) in the Model Summary table 4.10 above, when the control variable bank size was added in the analysis, ($F(1,409) = 58.063$; $P < .05$), the regression results indicate that the predictors variable, block ownership, institutional ownership, board size and board independence contributed to the overall relationship with performance as measured by Tobin's q. The F-statistic of 58.063 with the probability ratio of .000 indicated that the overall model was significant at 5% level of significance and that: block ownership, institutional ownership, board size and board independence were jointly significant in explaining the variation in the performance of commercial banks in terms of TBQ ratio. Hence, the null hypothesis that change in $R^2$ was equal to 0 was rejected. The research hypothesis that bank size reduced the error in predicting the

performance of commercial banks in Kenya in terms of TBQ ratio was supported. The increase in $R^2$ after including the control variables bank size in the analysis was .094.

Table 4.11 shows the regression results where estimated coefficient for each variable are shown when Tobin's q was used as a performance measure.

**Table 4.11: Regression Results of TBQ ratio[a]**

| Model | B | Unstandardised Std Error | Coefficients Beta | Standardized T | Sig. | Tolerance | V.I.F. |
|---|---|---|---|---|---|---|---|
| 1 (Constant) | -2.010 | .667 | | -3.012 | .003 | | |
| Block ownership | -.687 | .475 | -.109 | -1.565 | .118 | .376 | 2.659 |
| Institutional ownership | -.804 | .471 | .120 | -1.709 | .088 | .375 | 2.668 |
| Board independence | -1.754 | .473 | -.171 | -3.708 | .000 | .865 | 1.156 |
| Board size | 5.516 | .529 | .449 | 10.432 | .000 | .802 | 1.247 |
| 2 (Constant) | -4.045 | .680 | | -5.951 | .000 | | |
| Block ownership | -.553 | .418 | -.087 | -1.323 | .187 | .375 | 2.664 |
| Institutional ownership | -.509 | .443 | -.076 | -1.150 | .251 | .372 | 2.689 |
| Board independence | -.794 | .461 | -.077 | -1.723 | .086 | .801 | 1.249 |
| Board size | 2.234 | .656 | -.202 | 3.430 | .001 | .457 | 2.190 |
| Bank size | .987 | .130 | .420 | 7.690 | .000 | .531 | 1.884 |

[a].Dependent variable TBQ ratio.

The overall regression equation for this model is

$Y = -.4.045 - .553X_1 - .509X_2 - .794X_3 + 2.234X_4 + .987X_5$

Based on the statistical test of the beta coefficient ($t = 7.690$, $p<0.001$) for the control variable bank size, the null hypothesis that the slope / beta coefficient was equal to 0 (zero) was rejected. The research hypothesis that the relationship between corporate governance mechanisms (block ownership, board size, board independence and institutional ownership) and performance (TBQ ratio) of commercial banks in Kenya is significantly affected by bank size was supported. The beta coefficient/slope for the relationship between the TBQ ratio and the control variable bank size was .987.- invariably meaning that there is a direct relationship as signified by the positive coefficient. Implying that bigger bank size is associated with higher performance when

TBQ ratio is adopted as a measure of bank performance. The hypothesis that high bank sizes are associated with high performance in terms of TBQ ratio was supported.

Board size and bank size were found to be positively statistically significant at 5% level. Implying that; as board size and bank size of commercial banks in Kenya increases so does the TBQ ratio increases too. Institutional ownership, block ownership, and board independence were found not to be significant in this relationship. Meaning that the pressure exerted by: block owners, institutional owners and independent board of directors have no influence on TBQ ratio of commercial banks in Kenya. Although Institutional ownership, block ownership, and board independence were found not to be statistically significant, the fact that they had a negative beta coefficient was assessed as an important outcome. Board size had the highest beta coefficient ($\beta$ =2.234, P< .05), bank size ($\beta$ =.987, P<.05), institutional ownership ($\beta$=-.509, P>.05), block ownership ($\beta$= -.553, P>.05) and board independence ($\beta$= -.794, P >.05).

### 4.7 Heteroskedasticity Test

Plotting of error term observations or residuals against a Z factor was adopted to ascertain whether there was heteroskedasticity problem. Heteroskedasticity becomes a problem when the error term observations swing further away from zero as one moves to the right (Halcoussis, 2005). For the scatter plots in Appendix D and E,( on ROA and ROE) the error term observations are seen to mainly concentrate at the centre as one move away to the right an indication that there was no concern for heteroskedasticity problem when ROA and ROE were adopted as performance measures. However, for Appendix F where TBQ ratio was adopted as a performance measure, it is noted that as one moves to the right the error term observations are seen to swing away from zero, an indication that that there is heteroskedasticity problem.

## 4.8 Discussion of Research Findings

The findings in this section were drawn from descriptive and inferential statistics results. Under inferential statistics the decision rule was based on the significant t-statistics represented by P-values. Agbonifoh and Yomere, (1999), contend that the existence of a significant relationship can be inferred from significant t-statistic.

Upon selecting the regression model for interpretation (Tables: 4.6, 4.8 and 4.10) an examination for final assumptions of independence of errors was made with the help of the Durbin-Watson Statistic. This statistic was used in testing the presence of serial correlation among residuals (an assumption of independence of errors), which requires that residuals or errors in prediction should not follow a pattern from case to case. The results indicated that these statistics were: 1.540, 1.521 and 1.664 when ROA, ROE and TBQ ratio were adopted as performance measures respectively. The Durbin-Watson statistic ranges from 0 to 4. As a general rule of the thumb, the residuals are considered not to be correlated when the Durbin-Watson statistic is approximately 2- an acceptable range being 1.50 - 2.50 (Velnampy, 2011). The Durbin-Watson statistic for the three models was within the acceptable range an indication that there was no concern for autocorrelation

From the regression results (Tables 4.7, 4.9 and 4.11), two tests were used in ascertaining the presence of multicolinearity in the data used in the analysis. These were: variance inflation factor (V.I.F.) and Tolerance. The findings indicated that variance inflation factor (V.F.I.) was in the range of 1 and 10. That is: 2.664 for block ownership, 2.689 for institutional ownership, 1.249 for board independence, 2.190 for board size, and 1.884 for bank size. A variance inflation factor of greater than 10 is an indication that there is concern of multicolinearity problem (Myers, 1990). Since all these values were below 10 there was no concern for multicolinearity.

Tolerance test revealed the following figures: .375 for block ownership, .372 for institutional ownership, .801 for board independence, .457 for board size, and .531 for bank size. All tolerance figures were above .20 an indication that there was no concern of multicolinearity problem (Menard, 1995). These were supported by the correlation coefficients (Table 4.5) that did not suggest any concern for multicolinearity problems since all the correlation coefficients were below .80.

Looking at the model summary tables: 4.6, 4.8 and 4.10, one realizes that $R^2$ from which the changes in $R^2$ that were used in interpretation of regression results obtained were very low. The low $R^2$ values could be attributed to various reasons: In the first instance, in the area of corporate governance in banking firms there are fourteen independent variables (Appendix K). However, to achieve the general objective of the study only four of the fourteen independent variables were used. Given that each of these variables has an effect on performance, there exclusion could have led to low $R^2$ values being reported. At the same time, bank performance is affected by other factors other than corporate governance whose exclusion in this study could have led to low $R^2$ (Appendix L). Goldberger, (1991) argues that a high $R^2$ is not evidence in favor of the model and a low $R^2$ is not evidence against it either; the position that is supported by Gujarati (2004) who argues that the practice of choosing a model on the basis of highest $R^2$ is a kind of data mining that introduces pretest bias which can destroy some of the properties of ordinary least square estimators of classical linear regression model. Hence, low $R^2$ leading to low change in $R^2$ in this study did not imply that the model was unfit.

Based on the regression results in tables 4.7,4.9 and 4.11 it was found that there were more significant relationships between the proxies of corporate governance in the Kenyan commercial banks in ROE than ROA and TBQ ratio. On the same token, very high adjusted $R^2$ change was reported by ROE (11.7%) as compared to TBQ ratio (9.4%) and ROA (5.1%). Unlike $R^2$ that increases when a new variable is added to a regression

equation, adjusted $R^2$ may be negative or may increase or decrease depending on the contribution the new variable adds to the fit of the regression more than affects the correction for the loss of an additional degree of freedom Greene, (2008).

The difference between the maximum and minimum levels in performance in the three performance measures as per the descriptive statistics results (Table 4.4) was above 50%, an indication that there were large differences in the performance of Kenyan commercial banks (CBK 2001-2013). These wider disparities could have been attributed to the wider disparities in the parameters used in computation of performance and the fact that between 2008 and 2013 the top six commercial banks made between 62.76%-70.53% of the total profits, they held 43.67%-48.5% of the total assets and 54.4%-56.84% of shareholders equity compared to over 37 commercial banks that generated between 29.47%-37.24% of the total profits before tax, held 43.8%- 48.6% of the total assets and 43.16%-45.6% of shareholders equity (Appendix N).

The study further revealed that TBQ ratio as a performance measure suffers from heteroskedasticity problem. The heteroskedasticity problem in this case did not arise as a result of: wrong specification of the model, any intervention or an omission of a very important variable but due to sub-population differences. For example, between 2008 and 2013 between 9 - 11 commercial banks in Kenya were listed translating to 20% to 25% of all the banks that were in operation.TBQ ratio for unlisted banks were computed from data drawn from annual financial reports; whereas TBQ ratio for listed banks were computed from stock returns data available at the NSE. Based on the findings of Bhagat and Black (2002) that there is no relationship between TBQ ratio and corporate governance variables when data drawn from annual financial reports is used its computation, whereas there is some relationship when stock return data from the stock exchange is used. Heteroskedasticity became a problem when TBQ ratio was adopted as a performance.

TBQ ratio was seen to have the highest standard deviation of 142.224% when adopted as a performance indicator. The high standard deviation in TBQ ratio could be attributed to the high levels of volatility experienced in the Kenyan commercial banking sector that ensued from both internal and external economic shocks that were evident during the period of study. In the first instance, there were enormous bank failures in the 90's, that were subsequently followed by the Asian financial crisis of late 90s, the post election violence of 2007 and the world financial crisis 2007- 2008 that took a negative toll on the performance of banks.

Descriptive statistics results (Table: 4.4) indicate that the standard deviation was relatively low (3.829%) when ROA was adopted as a measure of performance indicating that the corporate governance mechanisms commercial banks had put in place were sufficiently assisting them secure assets and monitor the management efficiently to generate high profits. Given that ROA is a component of ROE (ROE= ROA X Gearing), given that TBQ ratio suffers from heteroskedasticity problem and suffers from high volatility when adopted as a performance measure, ROE emerged as the best measure of performance in the relationship between corporate governance and performance of commercial banks in Kenya in line with the findings of (Uwuigbe, 2012). The minimum ROE of -67% with a maximum return of 125% implied that all other things being equal, equity holders could get a maximum of at least 125% and loose up to 67% on their equity investment.

This study was anchored on five objectives as contextualized in 1.3 upon which the five hypotheses were tested based on ROE as a measure of performance. In line with the above findings and the objectives are discussed thereof:

**Objective 1: To evaluate the influence of block ownership on performance of commercial banks in Kenya.**

From the regression results (Table 4.9) there is a negative and statistically significant relationship between block ownership and ROE at 5% significance level. The negative coefficient of -.192 indicates that as block ownership in Kenyan commercial banks increases their performance in terms of ROE decreases. These results are supported by the correlation results (Table 4.5) that show a negative correlation coefficient (r) -.096 between block ownership and ROE that is statistically significant at 5% level of significant (.026). This invariably means that the higher the level of block ownership, the lower the performance of commercial banks in Kenya in terms of ROE. The above findings are in line with those of Deressa, (2013) that there is high block holding in the Kenyan commercial banking sector.

The above findings could be attributed to various reasons based on the findings in related literature as follows:

Levine, (2003) finds that: high block ownership raises new corporate governance issues in banking firms that negatively impact on performance. Block holders in Kenyan commercial banks may have paid themselves special dividends and were able to exploit business relationships with other firms they own at expense of the bank. This could have been made possible through the use of their voting power to secure such contracts at inflated prices hence impacting on the performance of the banks negatively.

Though block ownership provides incentives to monitor the activities of the management, it has been known to reduce the managers' initiative to acquire information. This makes managers play an inactive role in the decision making process that could have led to improved performance of commercial banks in Kenya. This especially the case when such decisions are likely to be interfered with by the

shareholders. This finding is in line with those of: Aghion & Tirole (1997) and Burkart *et al.* (1997) that under some circumstances the control imposed by block holders on managers may be too severe, subsequently restraining their initiative and incentives that could have led to improved performance. In Kenya, the origin of problems bedeviling many companies banks included ranging from errors, mistakes and outright frauds that negatively impact on performance have been attributed to block ownership among others (Ongore & K'Obonyo, 2011). With such an environment in place the interests of minority shareholders could be compromised in favor of majority shareholders in commercial banks leading to increased friction between the parties eventually affecting performance negatively.

The descriptive statistics results (Table 4.4) indicate that block holders in Kenyan commercial banking sector are diversified as indicated by the standard deviation of .21685. Implying that, they may be holding diversified portfolios hence further reduction of risk may not be in their interest. This leaves the management with the option of investing in very safe instruments such as government securities that do not fetch very high returns and extending loans to highly secure clients. This might have led to low levels of performance in some of these banks. These findings are in line with those of Denis *et al.* (1997) that block holders widely hold diversified portfolios hence further reduction of risk through diversification are not in their interest. This is further supported by the findings of Bolton and Von Tadden, (1998) that high block ownership limits diversification leading to reduction of tolerance towards risk by owners of a firm that may negatively affect firm performance. In the Kenyan context, block holders in banks in most cases demand that they should be consulted over a wide range of issues leading to delays in decision making processes that negatively impact on performance. On examination of the trade-off between ownership concentration and liquidity which may affect the informational role of the stock market Holmstrom and Tirole (1990) and

Admati *et al.* (1994) find that high ownership concentration reduces the owners tolerance towards risk that negates on firms performance.

The very thing that gives block holders in Kenyan banks ability to improve the management (voting power) also gives them the power to consume the resources of these institutions through poor management or by way of outright expropriation. This may help explain the negative relationship between block ownership and performance of these banks. These findings are in line with those Zulkarnain, (2007) that since block holders have controlling rights they may be in a better position to expropriate the company's assets and exploit the interest of the minority that in the long run negatively impact on company performance.

The above findings are further supported by 100% of the respondents who indicated that block holders have substantial voting powers in their banks; hence, they are able to influence decisions either to the advantage or disadvantage of the banks. Though the CBK Prudential guidelines have placed a cap on shares to be held by directors to 5%, some directors still find a way to beat these guidelines by making purchases through companies in which they have vested interest making them indirectly have a say on how these banks should be managed. Some of the block holders in the banks may not have the relevant skills and time to monitor the management. In view of this they tend to rely on the decisions of those who have relevant skills and time hence giving rise to the free rider problem thus negatively impacting on performance. This finding is in line with that of McColgan, (2001) that despite the high equity ownership stakes held, block holders may not have relevant skills and times making their presence in the company's board give rise to the free rider problem that can negatively impact on performance.

Most bank failures in Kenya occurred in the 90s and early 2000. Gugler & Weigand, (2003) and La Porta *et al.* (1999) observe that since the 90s the degree of block

ownership in firms around the world has been on increase; consequently, the potential expropriations of minority shareholders by controlling owners have become a normal occurrence. In line with the above findings, this study can also attribute the bank failures witnessed in Kenya during this period to poor performance resulting from block ownership.

Given that the relationship between block ownership and performance of commercial banks in Kenya is significant, we therefore reject the null hypothesis that there is no significant relationship between block ownership and the performance of commercial banks in Kenya and fail to reject the alternative hypothesis that there is a significant relationship between block ownership and the performance of commercial banks in Kenya and conclude that block ownership negatively influence the performance of commercial banks in Kenya.

**Objective 2: To determine the relationship between institutional ownership and performance of commercial banks in Kenya.**

The results from the correlation matrix (Table 4.5) show a negative correlation coefficient (r) -.080 between institutional ownership and ROE that is statistically significant at 5% level of significant (.049) an indication that as the level of institutional ownership in commercial banks in Kenya goes up their performance in terms of ROE decreases. These results are supported by those from the regression output (Table 4.9) which indicate that there is statistically significant negative relationship between institutional ownership and ROE of commercial banks in Kenya at 5% level of significance as shown by a negative beta coefficient (-.187) and p-value of .000. This implies that, as the level of institutional ownership increases commercial banks performance in terms of ROE decreases.

80.6% of the respondents cumulatively indicated that institutional investors in their banks had other engagements/ business relationships with them apart from being shareholders. The presence of such business engagements may have give rise to conflicts of interest that negatively affected the performance of these banks. These findings are in line with those of Coleman (2007) that institutional investors have other engagements with banks since they double as banks clients and their high presence may stifle the management's activities through their demands for favorable loan terms and favorable returns on investments thus impacting negatively on their performance. Heard and Sherman (1987) find that the dual activities of investment and business relationships between institutional investors and commercial banks could create a conflict between them; for the power gained from their equity ownership is tampered with by their reliance on the bank for business activities. Gorton & Kahl, (1999) and Pound (1988) hypothesis on conflict-of-interest suggests that in view of other profitable business relationship with the management of the incumbent firm; institutional investors are coerced into voting along with the management which in essence may negatively impact on firm performance since they may not be able to provide significant monitoring due to their own internal agency conflicts.

Given that institutional investors have a duty to monitor the management and the position they hold on various issues need to be taken seriously, the management of commercial banks are at times forced to cede to their demands regardless of whether they improve the performance of these institutions. This is because the ability of institutional shareholders to move in and out of the bank will not go without affecting the share price. These findings are in line with those of Han and Suk, (1998) and Hirschman, (1970) that due to the high ownership stakes and the amount of shares institutional investors can buy, their movement into the firm increases the share price and their exit drastically reduces the share price.

Institutional shareholders in banks can choose to adopt a passive behavior that makes them only interested in short-term returns of their investments by taking advantages from stock prices variations even if such fluctuations are temporary and have negative effect on the long-term performance. These findings are supported by the descriptive statistics results (Tables 4.4) which indicate that institutional ownership in Kenyan commercial banks is fairly spread (standard deviation of 16.402%). In view of this, they are able to choose the kind of investments different banks in which they own shares should venture into, hence restraining the ability of the banks management to participate in the same even if they impact on banks performance negatively. In view of the above top management turnover in Kenyan commercial banks has been a matter of concern since the performance of these banks have hampered by absence of memory on some of the major decisions that were made. These findings are in line with those of Denis and Denis (1995) that top management turnover is likely to be high in the presence of high ownership by financial institutions.

Given that institutional shareholding in Kenyan commercial banks is fairly spread, as per the descriptive statistics results and given that the extent to which institutional investors can monitor commercial banks depends on the size of shares held. Where institutional investors hold only a handful of shares they may not be keen in monitoring the management, this act subsequently impacts negatively on banks performance. These findings are in line with those of Maug (1998) that the incentive of institutional managers to monitor the firm depends on the size of their shareholding; where institutional shareholders only hold a handful of shares in a company they will have a low incentive to monitor the management as they can quickly liquidate their portfolio when the firm performance deteriorates. At the same time the extent to which institutional investors will collectively act as principals solely depend on their ability to undertake the coordination function in a cost effective manner. If coordination costs far outweigh the benefits of owning shares in a firm, as the case is in most Kenyan

commercial banks then the threat of their intervention will not be credible. This is in line with the findings of (Maug, 1998). We therefore reject the null hypothesis that there is no significant relationship between institutional ownership and the performance of commercial banks in Kenya and fail to reject the alternative hypothesis that there is a significant relationship between institutional ownership and performance of commercial banks in Kenya and hence conclude that there is a relationship between institutional ownership and performance of commercial banks in Kenya.

**Objective 3: To ascertain the effect of board independence on Kenya's commercial banks performance**.

Descriptive statistics results (Table: 4.4) indicate that the boards of directors of commercial banks in Kenya are independent; where 67% of the board of directors in these banks constitute of individuals who do not work for them. These results demonstrated that commercial banks in Kenya have adhered to the CBK prudential guidelines of 2001 which stipulate that: independent directors should constitute of 2/3 of the board size. The correlation analysis results (Table 4.5) indicate a negative correlation coefficient (r) -.075 between board independence and ROE that is not significant at 5% level (.063). The regression coefficient is -.023 that is also not significant at 5% level (.668).

These results indicate that although independent directors play a critical role in decision making processes in commercial banks in Kenya, there is no direct link between board independence and performance of these banks when ROE is adopted as a performance measure. This could be attributed to the fact that: board independence in itself is affected by financial performance. Commercial banks in Kenya have been known to react to bad performance by adding outside directors to the board an action that entails costs to the banks by way of fees, travel expenses, stocks and stock options that tend to offset their

effect on performance in line with the findings of (Adams & Mehran, 2002). At the same time the degree of independence in the board of these banks is unobservable since the choice of individuals to join the bank's board from outside is endogenous. This creates a missing link between board independence and performance of these banks in line with the findings of (Cole *et al.* 2008).

Belkhir, (2009), Monks and Nell, (2006) and Williams, *et. al. (*2006) find that commercial banks should only have a higher number of outside directors on the board when other corporate governance mechanisms are weak or have failed all together. Therefore since other corporate governance mechanisms have not failed all together in Kenyan commercial banks, board independence has not been seen to have a significant effect on their performance. At the same time; on average commercial banks in Kenya hold board meetings on a quarterly basis unless emergency issues arise. This translates to 8 to 12 days per annum. Considering this period, one may wonder if indeed independent directors put in sufficient effort in discharging their duties adequately for their impact on performance to be realized (Uwuigbe, 2012). On the same note boards of directors in banks are supposed to be custodians of effective corporate governance mechanisms by regularly holding meetings throughout the year so as to provide over-sight and guidance on issues on corporate governance (Ubank, 2014). But the fact that independent directors in Kenyan commercial banks are ineffective as demonstrated above makes them not to be effective custodians of corporate governance mechanisms in their banks hence have no effect on their performance.

69.7% of the respondents cumulatively indicated that independent directors in Kenyan commercial banks could not be independent in the execution of their duties due to the concern of personal relationship with the CEO. The CEO is the central person who seconds the names of these directors for appointment; hence such directors will always obey the CEO and would rarely vote against the CEO's proposal. CEOs with upper

hands in these banks could appoint independent directors to the boards just to please shareholders with an illusion that there is active monitoring in the banks activities when there is none at all. Hence making the presence of such directors have no impact on the performance of these banks. These findings are in line with those of Morck, (2007) that non-executive directors rarely blow the whistle on mismanagement by the executives. Raheja (2005) argues that whereas the non-executive directors are independent of the CEO, it is the CEO or inside directors who have got more information. From these findings it can be discerned that the exclusion of independent directors from the companies' boards may not have any effect on the company's performance. On the premise that the negative effect is not significant, we fail to reject the null hypothesis that there is no significant relationship between board independence and performance of commercial banks in Kenya and reject the alternative hypothesis that there is relationship between board independence and performance of commercial banks in Kenya and conclude that there is no relationship between board independence and performance of commercial banks in Kenya.

**Objective 4: To identify the relationship between board size and performance of commercial banks in Kenya.**

The results from the correlation analysis (Table 4.5) indicate a negative correlation coefficient (r) -.114, P-value =.010 between board size and ROE that is statistically significant at 5% level. The findings further indicate that between 2001 and 2013 the average board size of commercial banks was 8 directors. CBK (2013) advocates for a bigger board size in the banking sector owing to the complex nature of the environment in which they operate. For instance various committees in the banking sector are deemed not to be fully constituted in absence of board of directors.

But from the regression results it can be concluded that there is negative relationship between board size and performance of commercial banks in Kenya (Tables 4.11) The regression coefficient of the model is negative (-.196) with a *t* statistic of -2.580 which is less than zero. This implies that as the board size increases the performance of commercial banks in terms of ROE declines. However, from the descriptive statistics results one can conclude that the negative relationship between board size and performance of these commercial banks arises from the fact that they have got relatively the same board size. For instance between 2008 and 2013 between 51.85%-58.5% of the market share in the Kenyan banking sector was controlled by the top six commercial banks that had relatively the same board size as the 37 commercial banks that controlled between 41.15%-48.15% of the market share (Appendix M). Based on the findings of Cornet *et al*. (2009) that that big banks have larger boards. It can be argued that commercial banks in Kenya have a relatively large board size.

Owing to the low performance levels posted by small commercial banks in Kenya (Appendix I) it can be argued that the larger boards in these banks play more of a symbolic role rather than fulfilling their intended functions. Most of the boards are known to be characterized by a diminished sense of individual responsibility and increased bureaucracy that extends to the management team that may prevent meaningful dialogue needed to foster performance. This scenario creates a conducive environment for the CEO to control and manipulate the board making it provide the worst financial reporting oversight that lowers performance. These is in line with the findings of Lipton and Lorsch, (1992) that large boards prevent meaningful dialogue and that it is easier for the CEO to control and manipulate large boards, Yoshikawa and Phan, (2003), find that large boards are a creation of the CEO so as to entrench himself in the company and Jensen (1993) finds that as board size increases, they become less effective at monitoring the management because of free-riding problems amongst directors and increased decision-making time hence leading to negative performance.

There are two main issues that complicate empirical work on boards of directors in Kenyan commercial banks as they relate to performance. In the first place, both board size and commercial banks performance are endogenous. The commercial banks performance is as a result of the actions of previous managers and itself; a factor that influences the choice of subsequent directors. According to Hermalin and Weisbach (2001) negative relationship between board size and firm performance implies that firms should be encouraged to limit their board size so as to realize positive results. We therefore fail to reject the null hypothesis that there is no significant relationship between banks board size and performance of commercial banks in Kenya and reject the alternative hypothesis that there is a significant relationship between board size and ROE and conclude that there is a relationship between board size and performance of commercial banks in Kenya.

**Objective 5: To establish the effect of bank size in the relationship between corporate governance and performance of commercial banks in Kenya.**

The regression results in table 4.9 reveal that there is a positive and significant relationship at 5% level where the relationship between corporate governance and performance of commercial banks in Kenya is affected by bank size with a positive coefficient of .015. The coefficient of determination $R^2$ is .209 and $R^2$ change is .117 at 5% significance level; an indication that bank size has an effect in this relationship. The t statistics is 7.790 greater than zero implying that bank size has a positive influence in the relationship between corporate governance and performance of commercial banks in Kenya when ROE is adopted as a performance measure.

Descriptive statistics results indicate that commercial banks in Kenya are widely dispersed in terms of assets held with a maximum of Kshs.323, 594 million and a minimum of Kshs.750 million that deviated on both sides of the mean by 60.474%.

Implying that, these banks are widely dispersed in terms of assets held. The few banks that have large amount of assets normally outshine their counter parts that have low asset bases in terms of performance. The high disparity in assets these banks as shown by the standard deviation can be explained by the fact that a substantial amount of these assets were held by the top six commercial banks. For example between 2008 and 2013; 51.4%- 56.2% of the assets were held by the top six commercial banks that made 62.76%-70.5% of the total profit before tax with the difference of 43.8% - 48.6% of the assets being held by 37 commercial banks that made between 29.5%-37.2% of the total profit before tax (Appendix N).

The above findings may be attributed to the fact that; as commercial banks in Kenya become larger they are more capable to realize economies of scale and reduce the cost of gathering and processing information which impacts on performance positively. The above findings are in line with those of Uhomoibhi (2008), Dietrich and Wanzenried (2011) that bank size should be positively associated with performance given that banks with a larger size are able to diversify and move away from the traditional deposit-taking and lending business to cost-effective but riskier wholesale funding and market based activities. On the same context big banks have more products than small banks that enable them generate high revenues and profits. These findings are in line with those of Pasiouras and Kosmidou (2007) that larger banks have a wide range of products and loans diversification and are able to diversify their lending and deposit portfolios by moving away from traditional deposit-taking and lending practices to more cost-effective but riskier wholesale funding and market-based activities that lead to improved levels of performance. Based on these findings we reject the null hypothesis that the relationship between corporate governance and performance of commercial banks in Kenya is not significantly affected particularly by bank size and fail to reject the alternative hypothesis that the relationship between corporate governance and performance of commercial banks in Kenya is significantly affected by bank size. Hence

conclude that bank size has got an effect in the relationship between corporate governance and performance of commercial banks in Kenya.

# CHAPTER FIVE

# SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

## 5.1 Introduction

The main objective of this chapter is to is to provide a summary, draw a conclusion and make necessary recommendations based on the qualitative and quantitative analysis presented in chapter four. The summary of the results are correlated with empirical and available theoretical literature. The conclusion relates directly to the specific objectives. Whereas the recommendations are deducted from the conclusion and discussion of the findings. The chapter is structured in three sections: summaries of findings, conclusion and recommendations of the study.

## 5.2 Summary of Findings

The study sought to investigate the relationship between corporate governance and performance of commercial banks in Kenya. A pilot study was undertaken on one bank to test the reliability and validity of the questionnaire. The results of the pilot study were used in improving the questionnaire instrument making data collected using it achieve a relatively high level of consistency and could be generalized to be representative of the target population and used for further analysis.

Factor analysis was used in the study to reduce the number of constructs/variables especially for board independence to fewer that could clearly explain board independence aspect in governance of banks in Kenya. Out of the 43 commercial banks, 33 participated in the study. The proxies for corporate governance were: the internal corporate monitoring mechanisms (board size and board independence) and ownership governance mechanisms (institutional ownership and block ownership).Bank

performance indicators were ROA, ROE and Tobin's q ratio whereas bank size was adopted as a control variable. Both descriptive and inferential statistics were used in the analysis of the data collected as contextualized in chapter four.

Based on the higher number of significant variables in the regression results, ROA being a component of ROE, heteroskedasticity problem being realized when TBQ ratio was adopted as a performance measure, high standard deviation of TBQ as a performance measure and high adjusted $R^2$ when ROE was adopted as a performance measure. ROE was adopted as an indicator of performance in the study.

Empirical findings from this study were mixed. Others indicated that internal corporate monitoring mechanisms and ownership governance mechanisms had significant relationship with the performance indicators whereas others did not reveal any significant relationship. Block ownership was found to have a negative and significant relationship with commercial banks performance in terms of ROE. These findings were in line with those of the related literature.

High institutional shareholding was found to have a negative relationship with the performance of commercial banks in Kenya in terms of ROE. This could be attributed to investment and business relationship that such shareholders held with these banks that ended up compromising their ability to monitor and control the management. At the same time institutional shareholders are known to have their own agency problems that may not provide them sufficient time to monitor and control the management of these banks among other factors.

Board independence was found to have no significant relationship with the performance of commercial banks in Kenya in terms of ROE. This was attributed to the fact that a high caliber CEO could appoint independent directors to the board just to please shareholders with an illusion that there is active monitoring in of banks activities when

there is none at all. Such directors also rarely blow the whistle on mismanagements perpetrated by executives on the banks assets.

The findings of the study further indicated that commercial banks in Kenya had a relatively larger board sizes. The large board sizes affected their effectiveness due to: lack of meaningful dialogue among directors and the ability of the CEO to control and manipulate large boards. Bank size was found to have a positive relationship with the ROE of commercial banks in Kenya. This was attributed to the high number of products and loan diversification in large banks compared to small banks and their ability to reduce the cost of gathering and processing information that facilitates quick decision making owing to the amount of assets they had at their disposal.

### 5.3 Conclusion

The empirical findings have revealed a number of critical issues as regards corporate governance practices in the Kenyan banking industry. The study concludes that ROE is the best measure of performance in the study of corporate governance as it relates to performance in the Kenyan banking sector. These findings are in line with shareholders wealth maximization objective of the firm and the definition of corporate governance by Shleifer wand Vishny, (1997) that it is ways in which suppliers of finance to corporations assure themselves of getting a fair return on their investment. Where the fair return in is determined by ROE in this study. The findings further reveal that TBQ ratio yields better results in the study of corporate governance and bank performance when the focus is on listed banks. Otherwise it is bound to suffer from heteroskedasticity problem.

The study concludes that there is a negative and significant relationship between board size, institutional ownership and block ownership with bank performance in terms of ROE and that there is no relationship between board independence and performance of

commercial banks in Kenya in terms of ROE. Therefore if commercial banks in Kenya are to improve their performance they should direct their efforts towards other variables other than board independence. At the same time, commercial banks in Kenya should explore ways in which they should improve on boards' effectiveness.

Though there are studies in finance literature which indicate that board independence, institutional ownership and block ownership improves commercial banks performance, empirical findings in this study points to the contrary. The study reveals that both institutional ownership and block ownership have a negative relationship with the performance of commercial banks in Kenya when ROE is adopted as a performance measure. Implying that the significance of governance variables keep changing from time to time.

The negative and significant relationship among corporate governance variables with performance (ROE) and the presence of non significant variables may explain why within a period of less than one and a half decades, Central Bank of Kenya has issued three prudential guidelines (2001, 2007 & 2013) as a means of enhancing stability and soundness in the sector. The results further point to the fact that bank size has a positive effect in the relationship between corporate governance and performance of commercial banks in Kenya. Any time bank size has been introduced as a control variable the explanatory power of the model has been seen to improve.

The results further indicate that commercial banks in Kenya have embraced corporate governance as per 2001, 2006 and 2013 prudential guidelines. This is confirmed by drastic decline in bank failures and the fact that these banks have an average board size of 8 members which is more than a minimum of 5 as prescribed by the prudential guidelines where ⅔ of these board members are independent directors, though on overall the study finds that small banks in Kenya have bigger boards.

## 5.4 Recommendations

Based on the findings of this study, the researcher presents two types of recommendations namely: recommendations for areas of further research and recommendations for action.

### 5.4.1 Areas for further research

1. The study focused only on how certain sets of board characteristics impact on commercial banks performance in Kenya. While the characteristics covered were important, there are other diverse variables such managerial ownership, family ownership, remuneration committee; board meeting, capital structure and disclosure that could not be included hence should be considered in future studies.

2. Further studies should be undertaken with a view of understanding the history of ownership patterns of commercial banks in Kenya and the implication of these ownership patterns for the design of corporate governance regulations so as to foster performance of these banks.

### 5.4.2 Policy Recommendation

1. Based on the findings of this study, in order to improve the effectiveness of the board this study recommends that the regulator should have a seat in the boards of commercial banks in Kenya.

2. In view of the findings that commercial banks in Kenya have got relatively the same board size that impact on their performance negatively, the study recommends that the board size of individual banks should be pegged on the bank's capital tier group whereby banks in the same capital tier have similar board size.

3. Institutional shareholders should engage in business with banks in which they own shares at an arm's length and their activities monitored closely by the regulator.

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## APPENDICES

### Appendix 1: Questionnaire

**1.0 General information about the Bank**

The following questions are facts about your bank that you are required to clarify to the respondents in the survey on the relationship between corporate governance and performance of commercial banks in Kenya. The information you will provide will be held in confidence, will specifically be used for academic purposes and will not be disclosed to another party without your prior permission. Please respond to the statement by a tick (√) where appropriate except where instructions are given to the contrary.

1-Strongly Agree
2-Agree
3-Neither agree nor disagree
4-Disagree
5-Strongly disagree

1.1 Name of your Bank (optional)……..…

**2.0 Information on Respondent**

Respond to the statement by a tick (√) on appropriate; 1 much better, 2 slightly better, 3 about the same, 4 slightly worse and 5 much worse.

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 2.1 What is your view of corporate governance in your bank compared with other banks? | | | | | |
| 2.2 How do you compare your bank's current corporate governance practices with those of five years ago? | | | | | |

**3.0 Block Ownership**

3.1 How do you describe the ownership and control structure of the bank based on the following statements?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 3.1.1 The largest shareholder has a substantial voting right including that of companies he controls and effectively controls the bank | | | | | |
| 3.1.2 Two or more large shareholders collectively control the bank | | | | | |

3.2 What is the ownership/control structure of the biggest shareholders of your bank?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 3.2.1 Bank belongs to the same business group as the banks | | | | | |
| 3.2.2Bank mainly owned by foreign investors/financial institutions | | | | | |

3.3 What was the block ownership structure of your bank with respect to the following in percentage basis**?**

| **Year** | **Block ownership(**sum of the three largest stakes in the bank's equity by %) |
|---|---|
| 2001 | |
| 2007 | |
| 2013 | |

**4.0 Institutional Ownership**

4.0 Is your bank wholly or partially owned and controlled by the government?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 4.0.1 The bank is substantially owned and controlled by the government | | | | | |

4.1. Is your bank partially or wholly controlled by foreign financial institutions?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 4.1.1 The bank is owned and substantially controlled by foreign financial institutions | | | | | |

4.2 To what extend do you agree with the following statement about institutional investors in your bank?

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 4.2.1 They are required to disclose their voting policies with respect to their investment in the bank | | | | | |
| 4.2.2 They are required to disclose their governance policies with respect to their investment in the bank | | | | | |
| 4.2.3 They rarely use their vote. | | | | | |
| 4.2.4 They are required to disclose how they manage material conflict of interest that may affect the key ownership and performance rights. | | | | | |
| 4.2.5 They are allowed to consult each other on issues concerning their basic rights on share ownership | | | | | |
| 4.2.6 Their engagement in the bank is beyond just voting. | | | | | |

**5.0 Board independence**

5.1 Do you believe "independent directors" of your bank are truly independent from the CEO or controlling shareholders? Yes (1) No (2)

5.2 What do you think about the following reasons for "independent directors not being fully independent from the CEO or controlling shareholders?

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 5.2.1 The CEO has effectively selected the board members. | | | | | |
| 5.2.2 Concern over personal relationships with other directors. | | | | | |
| 5.2.3 Openly objecting to the management agenda is viewed as a defiance that is contrary to the norm. | | | | | |
| 5.2.4 Concern of possible blame or responsibility when their views turn out to be wrong in future | | | | | |
| 5.2.5 CEO and management team are supposed to be informed better on most issues and have better judgment | | | | | |

5.3 Who has the strongest voice in selection and dismissal of independent directors?

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 5.3.1 Board or nomination committee (autonomously) | | | | | |

5.4 What do you think about the role of the board of directors of your bank?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 5.4.1 It is a forum of serious discussion for all significant matters of the bank | | | | | |

5.5 Do you agree that your banks board is active and makes much contribution to the following tasks?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 5.5.1 Plays an important role in selecting, monitoring and replacing the CEO | | | | | |
| 5.5.2 Revises key executive and director remuneration | | | | | |
| 5.5.3 Reviewing potential conflicts of interest including related party transactions | | | | | |
| 5.5.4 Ensures integrity of the bank's financial reporting | | | | | |
| 5.5.4 Ensures proper disclosure and actively communicates with shareholders and stakeholders | | | | | |
| 5.5.5 Ensures effectiveness of various governance practices in the bank | | | | | |

5.6 Who has the strongest say in removing a poorly performing CEO and selecting a new one?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 5.6.1 It is effectively the board of directors | | | | | |

5.7 How good do you think is access to information for independent directors of your bank?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 5.7.2 Have access to the banks business records and books of accounts at any time | | | | | |
| 5.7.3 Always have enough information availed to them in time to be digested before every board meeting | | | | | |
| 5.7.4 Are permitted to obtain the services of outside legal, financial and other professional advisors at the bank's expense | | | | | |

5.8 What do you think about the financial compensation for independent directors in your bank?

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 5.8.1 Adequate | | | | | |

5.9 How serious is your banks concern about potential director liability (for the breach of duty of care)?

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 5.9.1 Very serious | | | | | |

**6.0 Board size**

6.1 What was the board size of your bank during the following periods? Please tick where appropriate

1-More than 10 members, 2-between 1-10,3-between 1-8,3-between 1-8,4, between1-6,4 and between-1-4

| Year | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 2001 | | | | | |
| 2007 | | | | | |
| 2013 | | | | | |

6.2 How can you justify the board size you have mentioned 7.1 above

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 6.2.1 Need for professional diversification in decision making | | | | | |
| 6.2.2 To check the excesses of the CEO | | | | | |

**7.0 Bank performance**

What is your take on the following performance measures in your bank?

| Statement | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| 7.1 Your bank has good improvement of ROA in the last five years | | | | | |
| 7.2 Your bank has better ROA than industry average | | | | | |
| 7.3 Your bank has a good improvement of ROE in the last five years | | | | | |
| 7.4 Your bank has better ROE than industry average | | | | | |
| 7.5 Your bank has a good improvement in Tobin's q in the last three years | | | | | |
| 7.6 Your bank has a better Tobin's q than industry average | | | | | |

**8.0 Bank size**

To what extend do you agree with the following statements as to why banks acquire a large size?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 8.1 To reduce risk of failure | | | | | |
| 8.2 To take advantages of economies of scale and improve performance | | | | | |
| 8.3 Due to recent revolution in information technology | | | | | |
| 8.4 To have wider coverage that will satisfy customers | | | | | |

**9.0 General corporate governance position in banks**

9.1 Which of the following enhances corporate governance in your bank?

| **Statement** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| 9.1.1 Making the internal corporate governance mechanisms work better | | | | | |
| 9.1.2 Relying on the efficacy of external corporate governance mechanisms in place | | | | | |
| 9.1.3 Strictly adhering to the standards of accounting, audit and disclosure that have been adopted by the bank | | | | | |
| 9.1.4 Controlling related party transactions | | | | | |

**Thank You for your Co-operation.**

## Appendix 2: Licensed Commercial Banks in Kenya

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank (Kenya)
6. CFC Stannic Bank
7. Chase Bank (Kenya)
8. Citibank NA
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Co-operative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Ecobank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. First Community Bank
22. Giro Commercial Bank
23. Guardian Bank
24. Gulf African Bank
25. Habib Bank Ltd
26. Habib Bank AG Zurich
27. Housing Finance Company of Kenya
28. I&M Bank
29. Imperial Bank Kenya
30. Jamii Bora Bank
31. Kenya Commercial Bank
32. K-Rep Bank
33. Middle East Bank Kenya
34. National Bank of Kenya
35. NIC Bank
36. Oriental Commercial Bank
37. Paramount Universal Bank
38. Prime Bank (Kenya)
39. Standard Chartered Kenya
40. Trans National Bank Kenya
41. United Bank for Africa Kenya Ltd
42. Victoria Commercial Bank
43. Fina Bank

**(Source: CBK 2013)**

## Appendix 3: Corporate Governance and Bank Performance

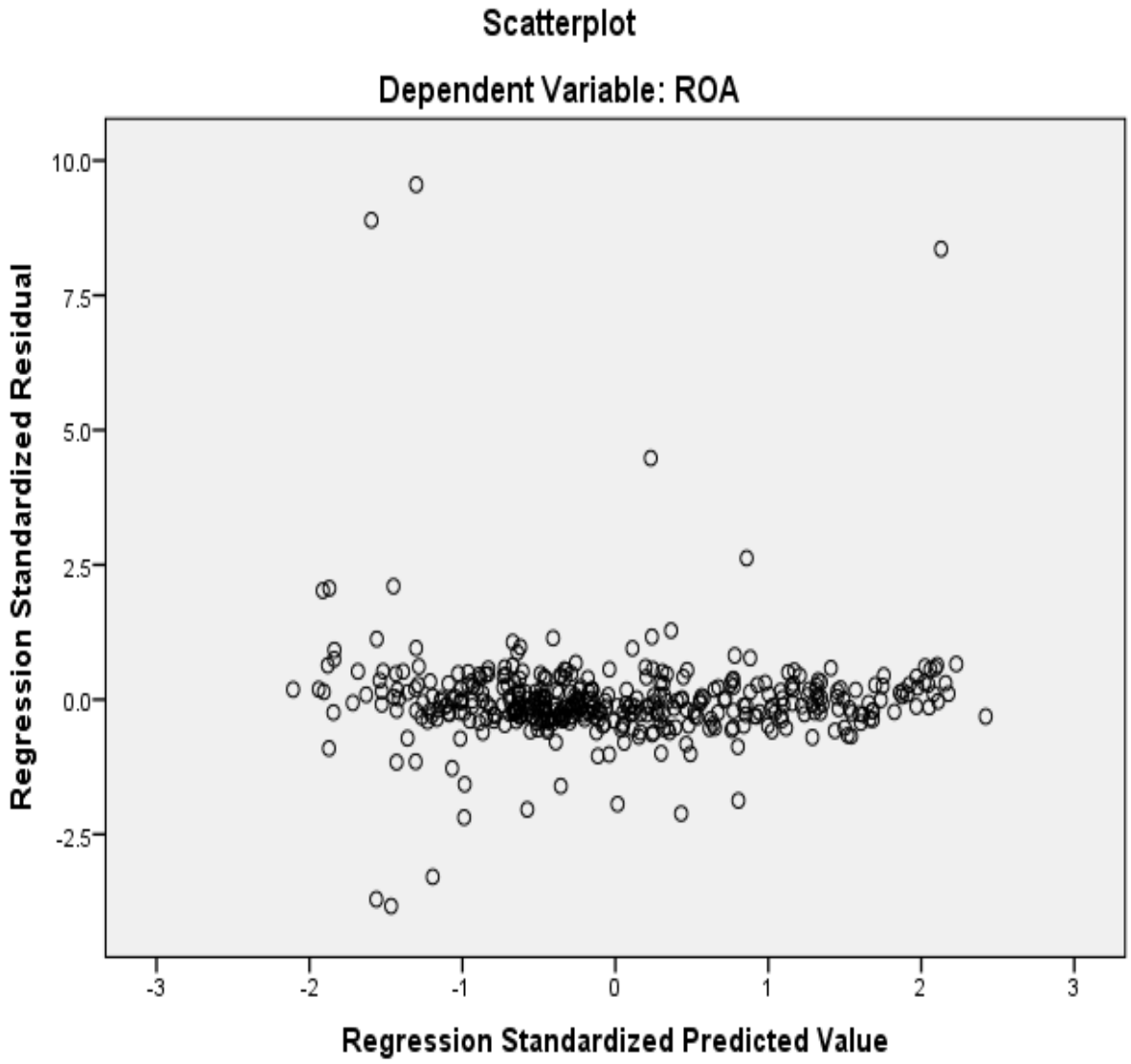
### Main studies that link Corporate Governance and Bank Performance

| Author | Performance Indicators | Country | Observation Period | Board Size | Board Composition | Institutional ownership | Block Ownership |
|---|---|---|---|---|---|---|---|
| Romano et. al., (2012) | DEA | Italy | 2007-2008 | * | * | | |
| Pi and Timme, (1993) | ROA and stochastic frontier model | U.S.A. | 1988-1990 | | * | | |
| Adams and Mehran, (2008) | ROA and Tobin's q | U.S.A. | 1986-1999 | ** | * | | |
| Adams and Mehran, (2005) | ROA and Tobin's q | U.S.A. | 1959-1999 | ** | * | | |
| Love and Rachnisky, (2007) | ROA,ROE | Russia and Ukraine | 2003-2006 | * | * | | |
| Agoraki *et al.* (2009) | Stochastic frontier model | Europe | 2002-2006 | * | Non linear | | |
| Al- Hawary, (2012) | Tobin's q | Jordan | 2002-2009 | * | ** | | * |
| Trabelsi, (2010) | Tobin's q | Tunisia | 1997-2007 | *** | ** | | |
| Sierra, *et al.*(2006) | ROA and shareholder return | U.S.A. | 1992-1997 | *** | ** | | |
| Selvam *et al.*(2006) | Tobin's Q and ROCE | India | 2004 | * | ** | | |
| Guo Rong et. al.(2012) | ROA,Quality of revenue and Tobin's q | U.S.A. | 1990-1991 | ** | | | |

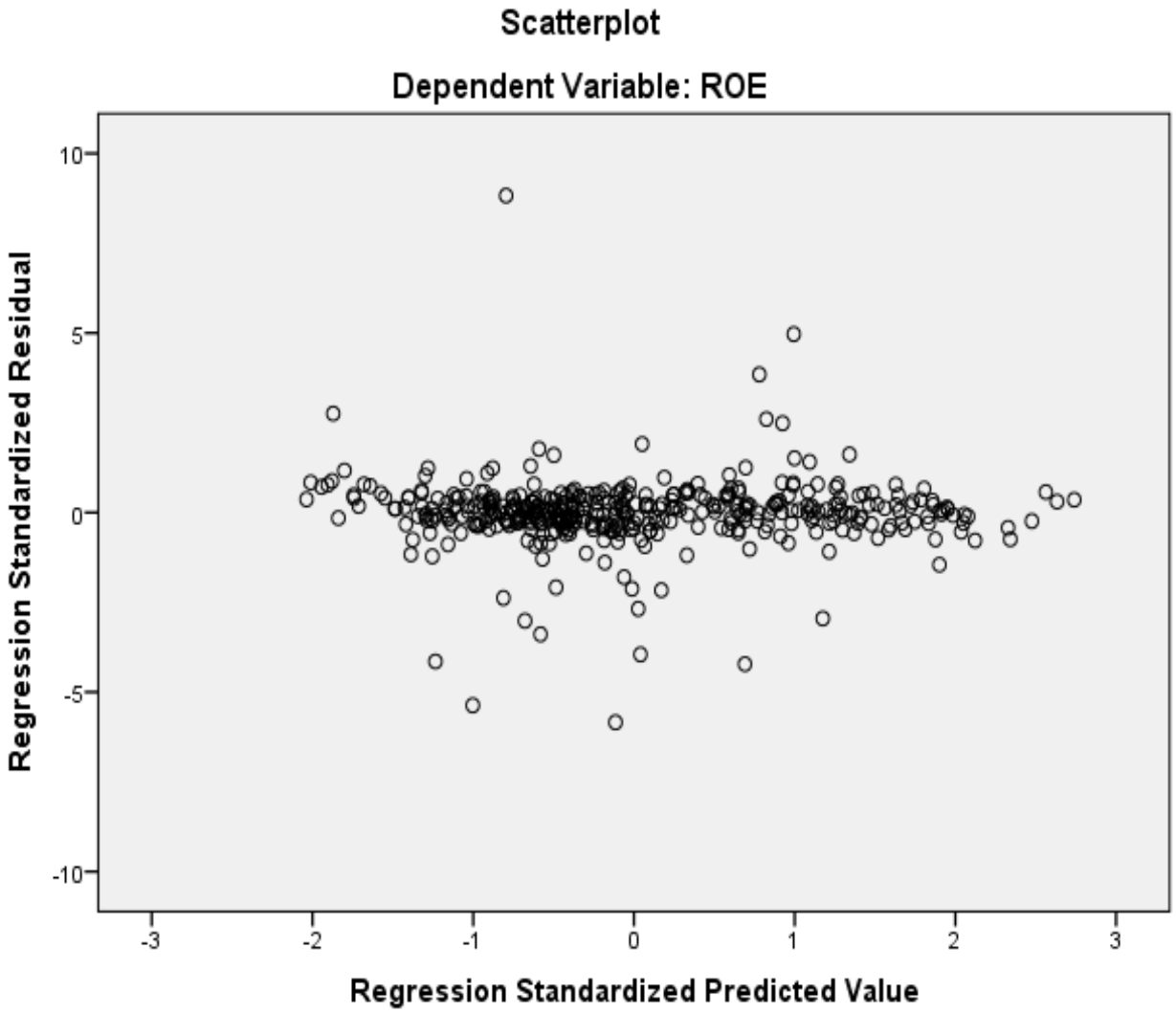
| Author | Performance Indicators | Country | Observation Period | Board Size | Board Composition | Institutional ownership | Block Ownership |
|---|---|---|---|---|---|---|---|
| Al-Manaseer, (2012) | ROA,ROE,PM and EPS | Jordán | 2007-2009 | *** | ** | | |
| Uwuigbe,(2011) | ROE and ROA | Nigeria | 2006-2008 | *** | *** | | |
| Mang'unyi, (2011) | ROA and ROE | Kenya | | | | * | * |
| Fung, (2009) | ROA,ROE,Mkt to book ratio,RAROC | Hong Kong | 2005-2007 | ** | | | |
| Spong and Sullivan, (2007) | Distance to default | U.S.A. | 2007 | | | | ** |
| Htay, (2012) | ROA and ROE | Malaysia | 1996-2005 | ** | *** | *** | |
| Ermina and Maria, (2010) | ROA,ROE P/E and Investment return | Europe,Canada ,Australia and Japan | 2004-2008 | * | * | * | * |
| De Andres and Vallelado, (2008) | Tobin's q ,ROA, annual Mkt return of bank shareholder | Canada, U.S.A., U.K. Spain, France, Italy | 1996-2005 | Inverted U shaped | | | |
| Poudel and Hovey, (2012) | NPA | Nepal | 1997-1998 | ** | ** | ** | |
| Bino and Tomar, (2007) | ROA and ROE | Jordan | 1997-2006 | * | ** | ** | ** |

* No relationship between the corporate governance mechanism and bank performance
** +ve relationship between the corporate governance mechanism and bank performance
*** -ve relationship between the corporate governance mechanism and bank performance

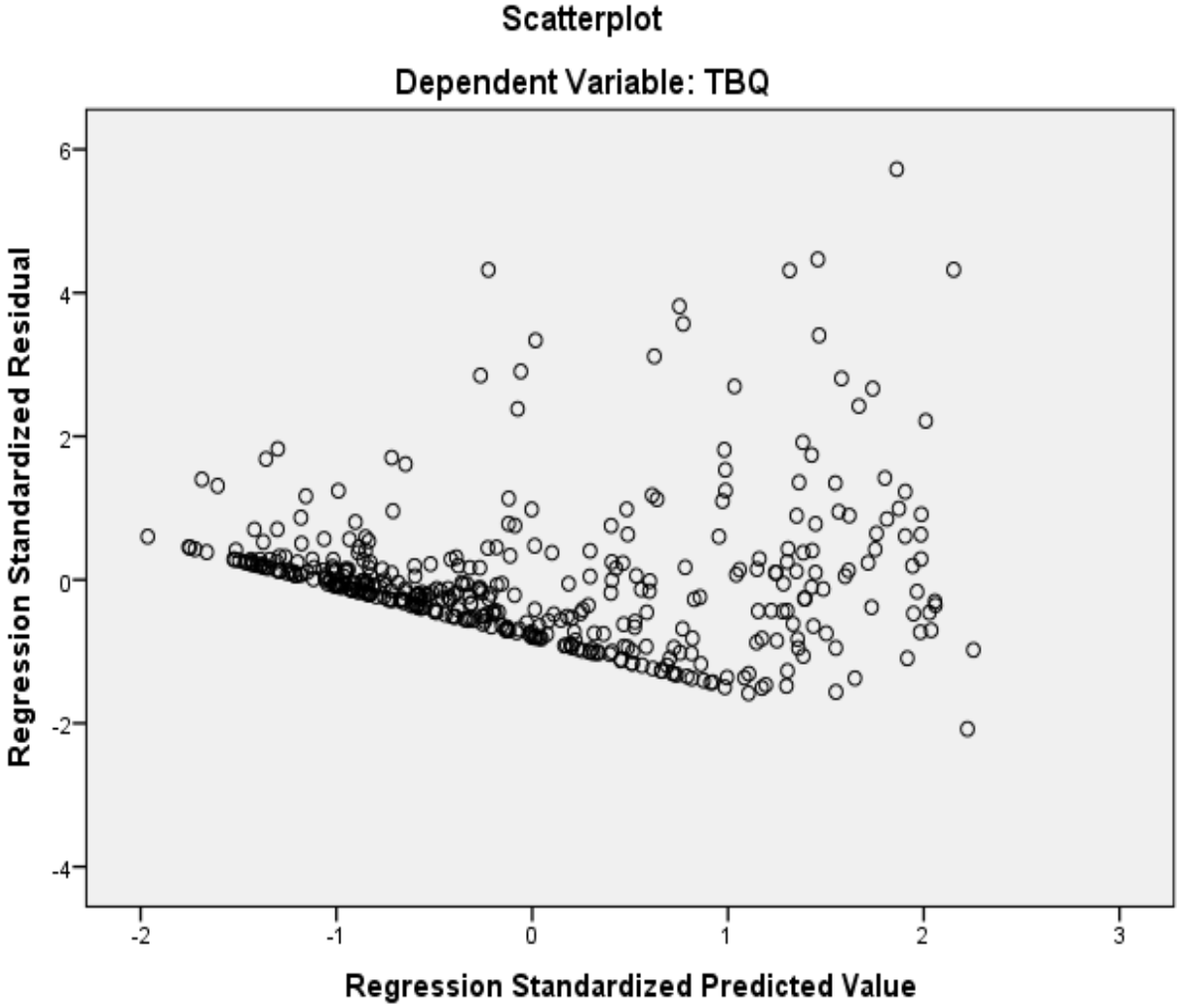
**Appendix 4: ROA Scatter Plot**



**Appendix 5: ROE Scatter Plot**



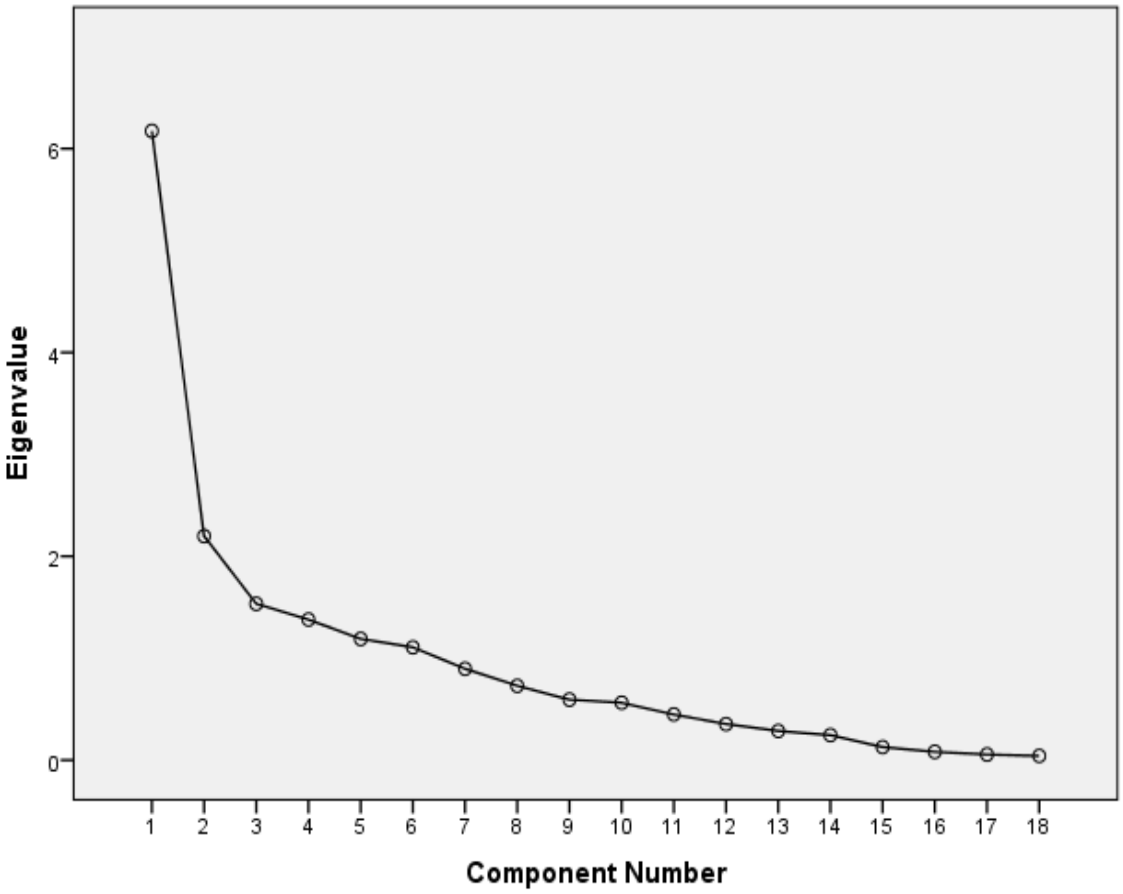
**Appendix 6: TBQ Ratio Scatter Plot**



## Appendix 7: Eigenvalues

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | | Rotation Sums of Squared Loadings | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 6.174 | 34.298 | 34.298 | 6.174 | 34.298 | 34.298 | 4.700 | 26.113 | 26.113 |
| 2 | 2.198 | 12.212 | 46.510 | 2.198 | 12.212 | 46.510 | 2.573 | 14.294 | 40.407 |
| 3 | 1.534 | 8.521 | 55.031 | 1.534 | 8.521 | 55.031 | 1.724 | 9.579 | 49.986 |
| 4 | 1.379 | 7.661 | 62.692 | 1.379 | 7.661 | 62.692 | 1.689 | 9.381 | 59.367 |
| 5 | 1.190 | 6.609 | 69.301 | 1.190 | 6.609 | 69.301 | 1.554 | 8.636 | 68.003 |
| 6 | 1.107 | 6.148 | 75.449 | 1.107 | 6.148 | 75.449 | 1.340 | 7.446 | 75.449 |
| 7 | .896 | 4.978 | 80.427 | | | | | | |
| 8 | .729 | 4.050 | 84.477 | | | | | | |
| 9 | .593 | 3.296 | 87.773 | | | | | | |
| 10 | .563 | 3.129 | 90.902 | | | | | | |
| 11 | .448 | 2.488 | 93.390 | | | | | | |
| 12 | .354 | 1.964 | 95.354 | | | | | | |
| 13 | .286 | 1.588 | 96.943 | | | | | | |
| 14 | .245 | 1.362 | 98.305 | | | | | | |
| 15 | .128 | .709 | 99.014 | | | | | | |
| 16 | .081 | .452 | 99.466 | | | | | | |
| 17 | .055 | .304 | 99.770 | | | | | | |
| 18 | .041 | .230 | 100.000 | | | | | | |

## Appendix 8: Scree Plot



## Appendix 9: Kenya's Commercial Banks Performance 2001-2013

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **1.BARCLAYS BANK (K) LTD** | **2001** | 0.0469 | 0.259210526 | 1.313438553 |
| | **2002** | 0.024 | 0.176193813 | 1.998625088 |
| | **2003** | 0.0491 | 0.303121031 | 5.175195064 |
| | **2004** | 0.0467 | 0.299074447 | 3.313786092 |
| | **2005** | 0.0418 | 0.282841314 | 3.091652121 |
| | **2006** | 0.044 | 0.302247342 | 7.035190419 |
| | **2007** | 0.042 | 0.279549078 | 6.107549533 |
| | **2008** | 0.047 | 0.269999511 | 3.318184039 |
| | **2009** | 0.053 | 0.251590252 | 2.524163569 |
| | **2010** | 0.0624 | 0.336850469 | 2.632703003 |
| | **2011** | 0.0718 | 0.276220785 | 2.425300277 |
| | **2012** | 0.07 | 0.295473752 | 2.882287124 |
| | **2013** | 0.058 | 0.235488555 | 2.919261067 |
| **2. STANDARD CHARTERED BANK (K) LTD** | **2001** | 0.0475 | 0.395444029 | 2.079058863 |
| | **2002** | 0.043 | 0.38826423 | 2.519341883 |
| | **2003** | 0.0624 | 0.433007297 | 7.331780779 |
| | **2004** | 0.0383 | 0.302160647 | 5.472538347 |
| | **2005** | 0.0336 | 0.254875378 | 3.942434039 |
| | **2006** | 0.033 | 0.25923001 | 5.503751234 |
| | **2007** | 0.053 | 0.316965922 | 5.132374496 |
| | **2008** | 0.047 | 0.290633968 | 3.784231672 |
| | **2009** | 0.0539 | 0.339919529 | 3.146058917 |
| | **2010** | 0.0537 | 0.263931927 | 3.643001623 |
| | **2011** | 0.0503 | 0.283603131 | 2.232867629 |
| | **2012** | 0.059 | 0.262817371 | 2.374027546 |
| | **2013** | 0.06 | 0.257091313 | 2.292475362 |
| **3. COMMERCIAL BANK OF AFRICA (K) LTD** | **2001** | 0.0234 | 0.199324324 | 0.059573604 |
| | **2002** | 0.018 | 0.148544266 | 0.109235588 |
| | **2003** | 0.03108 | 0.193877551 | 0.089658774 |
| | **2004** | 0.0194 | 0.143730887 | 0.332670197 |
| | **2005** | 0.0168 | 0.223534558 | 0.198743407 |
| | **2006** | 0.029 | 0.242937853 | 0.601317957 |
| | **2007** | 0.035 | 0.215889831 | 0.337260922 |
| | **2008** | 0.033 | 0.247201853 | 0.438517094 |
| | **2009** | 0.03 | 0.178145888 | 0.417507418 |
| | **2010** | 0.0424 | 0.226102719 | 0.778966203 |
| | **2011** | 0.358 | 0.165072974 | 0.665058846 |
| | **2012** | 0.04 | 0.226870544 | 0.330939822 |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| | **2013** | 0.036 | 0.252818387 | 1.118429556 |
| **4. NIC BANK (K) LTD** | **2001** | 0.0384 | 0.105789254 | 0.514879217 |
| | **2002** | 0.031 | 0.091673339 | 0.612008907 |
| | **2003** | 0.0351 | 0.094332298 | 1.455745342 |
| | **2004** | 0.0212 | 0.09871407 | 1.558623298 |
| | **2005** | 0.0173 | 0.103472968 | 1.4754744 |
| | **2006** | 0.023 | 0.150527009 | 2.768774704 |
| | **2007** | 0.032 | 0.157028282 | 1.304558886 |
| | **2008** | 0.034 | 0.185052102 | 3.19826087 |
| | **2009** | 0.033 | 0.156213192 | 1.365080241 |
| | **2010** | 0.0441 | 0.207111218 | 1.977003232 |
| | **2011** | 0.0457 | 0.255858586 | 0.957328485 |
| | **2012** | 0.042 | 0.215466313 | 1.378635115 |
| | **2013** | 0.046 | 0.187964381 | 1.786232885 |
| **5. TRANSNATIONAL BANK (K) LTD** | **2001** | 0.08 | 0.365217391 | 0.106882591 |
| | **2002** | 0.04 | 0.157419355 | 0.14751773 |
| | **2003** | 0.08203 | 0.113033449 | 0.239554318 |
| | **2004** | 0.3654 | 0.114965312 | 0.959625567 |
| | **2005** | 0.0223 | 0.035849057 | 0.570283019 |
| | **2006** | 0.016 | 0.055258467 | 1.974872542 |
| | **2007** | 0.022 | 0.17225748 | 1.456431535 |
| | **2008** | 0.033 | 0.106882591 | 0.322562979 |
| | **2009** | 0.0236 | 0.067924528 | 0.293024981 |
| | **2010** | 0.0333 | 0.092147956 | 0.468852459 |
| | **2011** | 0.0405 | 0.116465863 | 0.234422836 |
| | **2012** | 0.037 | 0.116139586 | 0.27766129 |
| | **2013** | 0.023 | 0.084537186 | 0.547954722 |
| **6. KENYA COMMERCIAL BANK (K) LTD** | **2001** | 0.0019 | 0.037308773 | 3.853262566 |
| | **2002** | -0.035 | -0.39469609 | 4.922570654 |
| | **2003** | 0.014499 | 0.127731996 | 1.447223217 |
| | **2004** | 0.132 | 0.092424242 | 1.485314685 |
| | **2005** | 0.0183 | 0.133306884 | 2.237135489 |
| | **2006** | 0.026 | 0.202667814 | 4.140154905 |
| | **2007** | 0.031 | 0.204998107 | 4.307913669 |
| | **2008** | 0.03 | 0.180727462 | 4.078342107 |
| | **2009** | 0.0357 | 0.199657955 | 3.420452552 |
| | **2010** | 0.0517 | 0.183439816 | 2.772808587 |
| | **2011** | 0.0498 | 0.24314151 | 1.255452472 |
| | **2012** | 0.052 | 0.209537845 | 9.125949439 |
| | **2013** | 0.055 | 0.200429549 | 7.741501178 |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **7. IMPERIAL BANK (K) LTD** | **2001** | 0.0338 | 0.008264463 | |
| | **2002** | 0.035 | 0.016129032 | |
| | **2003** | 0.0381 | 0.253991292 | 0.273361227 |
| | **2004** | 0.0426 | 0.304635762 | 0.043991701 |
| | **2005** | 0.0308 | 0.16006216 | 0.23688672 |
| | **2006** | 0.031 | 0.173774666 | 0.905717407 |
| | **2007** | 0.046 | 0.226097414 | 0.700207469 |
| | **2008** | 0.049 | 0.267355135 | 0.116122673 |
| | **2009** | 0.0509 | 0.258845438 | 0.13541306 |
| | **2010** | 0.0643 | 0.176858513 | 0.334894614 |
| | **2011** | 0.0637 | 0.693511008 | 0.245483061 |
| | **2012** | 0.055 | -0.042021011 | 0.383190828 |
| | **2013** | 0.058 | -0.026548673 | 0.757655755 |
| **8. CFC STANBIC BANK** | **2001** | 0.0137 | -0.516908213 | 1.739130435 |
| | **2002** | 0.015 | 0.201892744 | 1.741324921 |
| | **2003** | 0.00888 | 0.187096774 | 4.258064516 |
| | **2004** | 0.0191 | 0.139803582 | 4.824956672 |
| | **2005** | 0.0154 | 0.145391819 | 5.766387383 |
| | **2006** | 0.021 | 0.181818182 | 5.069003286 |
| | **2007** | 0.031 | 0.195121951 | 5.985722784 |
| | **2008** | 0.015 | 0.105085698 | 2.306973869 |
| | **2009** | 0.0135 | 0.097629866 | 1.512437677 |
| | **2010** | 0.0196 | 0.209666168 | 2.059107324 |
| | **2011** | 0.0223 | 0.30817734 | 0.849818351 |
| | **2012** | 0.035 | 0.170852338 | 0.957196126 |
| | **2013** | 0.041 | 0.221446786 | 2.018212415 |
| **9.DEVELOPMENT BANKOF KENYA (K) LTD** | **2001** | 0.025 | 0.107495069 | 0.277368421 |
| | **2002** | 0.011 | 0.072929543 | 0.307328605 |
| | **2003** | 0.33782 | 0.114317425 | 0.318396226 |
| | **2004** | 0.0336 | 0.097207859 | 0.165678423 |
| | **2005** | 0.0505 | 0.11047619 | 0.537382075 |
| | **2006** | 0.034 | 0.082397004 | 1.760360524 |
| | **2007** | 0.031 | 0.097027972 | 1.554460581 |
| | **2008** | 0.026 | 0.097640358 | 0.319961665 |
| | **2009** | 0.0227 | 0.099046222 | 0.528332921 |
| | **2010** | 0.0222 | 0.107454668 | 0.444496487 |
| | **2011** | 0.0137 | 0.069142125 | 0.210683814 |
| | **2012** | 0.008 | 0.044063647 | 0.248465799 |
| | **2013** | 0.018 | 0.103675261 | 0.443769799 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **10. I&M BANK (K) LTD** | **2001** | 0.0114 | 0.060822898 | 0.046699875 |
| | **2002** | 0.012 | 0.066783831 | 0.055806258 |
| | **2003** | 0.023495 | 0.114976415 | 0.098924731 |
| | **2004** | 0.0237 | 0.13830362 | 0.188161876 |
| | **2005** | 0.02 | 0.168287938 | 0.1937046 |
| | **2006** | 0.031 | 0.232200358 | 0.430753138 |
| | **2007** | 0.043 | 0.228342384 | 0.23503588 |
| | **2008** | 0.0404 | 0.215690054 | 0.174465505 |
| | **2009** | 0.0394 | 0.162959968 | 0.099841726 |
| | **2010** | 0.048 | 0.163174114 | 0.119501975 |
| | **2011** | 0.058 | 0.223296767 | 0.188404399 |
| | **2012** | 0.052 | 0.209872823 | 0.168410042 |
| | **2013** | 0.055 | 0.2296336 | 0.222048686 |
| **11.MIDDLE EAST BANK (K) LTD** | **2001** | 0.0155 | 0.075524476 | 0.172064777 |
| | **2002** | 0.012 | 0.058577406 | 0.197005516 |
| | **2003** | 0.022865 | 0.074224022 | 0.523952096 |
| | **2004** | 0.0081 | 0.032697548 | 0.088692946 |
| | **2005** | 0.0206 | 0.099496222 | 0.274174528 |
| | **2006** | 0.019 | 0.080760095 | 0.851238165 |
| | **2007** | 0.028 | 0.067121729 | 0.700207469 |
| | **2008** | 0.009 | 0.034207526 | 0.130065717 |
| | **2009** | 0.0137 | 0.048672566 | 0.110994311 |
| | **2010** | 0.0511 | 0.140214216 | 0.152224824 |
| | **2011** | 0.0199 | 0.083636364 | 0.067440402 |
| | **2012** | 0.008 | 0.041814947 | 0.076029926 |
| | **2013** | 0.014 | 0.06893617 | 0.135295671 |
| **12.BANK OF AFRICA** | **2001** | 0.0071 | 0.041493776 | 0.001720648 |
| | **2002** | 0.007 | 0.059840426 | 0.001970055 |
| | **2003** | 0.000246 | 0.001351351 | 0.005239521 |
| | **2004** | -0.0062 | 0.229583975 | 0.001419087 |
| | **2005** | 0.0009 | 0.01035503 | 0.006580189 |
| | **2006** | 0.007 | 0.054192229 | 0.025537145 |
| | **2007** | 0.02 | 0.091844814 | 0.021006224 |
| | **2008** | 0.007 | 0.0433213 | 0.006763417 |
| | **2009** | 0.0153 | 0.07646356 | 0.006215681 |
| | **2010** | 0.0181 | 0.16434635 | 0.013395785 |
| | **2011** | 0.0143 | 0.118792808 | 0.009171895 |
| | **2012** | 0.013 | 0.116174975 | 0.01034007 |
| | **2013** | 0.02 | 0.157210583 | 0.022551082 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **13.K-REP BANK (K) LTD** | **2001** | | | |
| | **2002** | | | |
| | **2003** | | | |
| | **2004** | | | |
| | **2005** | 0.0122 | 0.037313433 | 0.01754717 |
| | **2006** | 0.028 | 0.11247216 | 0.061289148 |
| | **2007** | 0.026 | 0.128683694 | 0.056016598 |
| | **2008** | -0.056 | -0.326750449 | 0.011966046 |
| | **2009** | -0.0376 | -0.188798555 | 0.009323522 |
| | **2010** | 0.0144 | 0.044041451 | 0.014004684 |
| | **2011** | 0.0275 | 0.129977461 | 0.006878921 |
| | **2012** | 0.032 | 0.128356254 | 0.009074932 |
| | **2013** | 0.042 | 0.192719486 | 0.020023759 |
| **14.GUARDIAN BANK (K) LTD** | **2001** | 0.0115 | 0.061417323 | 0.220242915 |
| | **2002** | 0.012 | 0.067873303 | 0.260047281 |
| | **2003** | 0.013 | 0.054331865 | 0.71257485 |
| | **2004** | 0.0244 | 0.05034965 | 0.127717842 |
| | **2005** | 0.0099 | 0.051519155 | 0.416745283 |
| | **2006** | 0.008 | 0.043147208 | 1.327931537 |
| | **2007** | 0.004 | 0.021118012 | 1.12033195 |
| | **2008** | 0.007 | 0.034730539 | 0.218510405 |
| | **2009** | 0.0083 | 0.043528064 | 0.195349988 |
| | **2010** | 0.0139 | 0.079113924 | 0.28618267 |
| | **2011** | 0.0192 | 0.108920188 | 0.142973651 |
| | **2012** | 0.019 | 0.127973749 | 0.18536096 |
| | **2013** | 0.03 | 0.184738956 | 0.404263464 |
| **15.PRIME BANK (K) LTD** | **2001** | 0.0143 | 0.084033613 | 0.003441296 |
| | **2002** | 0.015 | 0.092081031 | 0.004728132 |
| | **2003** | 0.0157 | 0.100993377 | 0.004245283 |
| | **2004** | 0.0171 | 0.113432836 | 0.002483402 |
| | **2005** | 0.014 | 0.121883657 | 0.007676887 |
| | **2006** | 0.015 | 0.104704097 | 0.027239621 |
| | **2007** | 0.022 | 0.124091381 | 0.028008299 |
| | **2008** | 0.023 | 0.107317073 | 0.008324206 |
| | **2009** | 0.0233 | 0.131810767 | 0.008435568 |
| | **2010** | 0.0237 | 0.155464341 | 0.024355972 |
| | **2011** | 0.0303 | 0.222875468 | 0.008740276 |
| | **2012** | 0.027 | 0.180838323 | 0.011605208 |
| | **2013** | 0.038 | 0.305020633 | 0.026793955 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **16.BANK OF BARODA (K) LTD** | **2001** | 0.0119 | 0.135770235 | 0.131801619 |
| | **2002** | 0.007 | 0.098795181 | 0.163514578 |
| | **2003** | 0.0178 | 0.119076549 | 0.86242515 |
| | **2004** | 0.0317 | 0.208462332 | 0.920685146 |
| | **2005** | 0.0235 | 0.222637979 | 0.586185142 |
| | **2006** | 0.029 | 0.206650831 | 2.150227604 |
| | **2007** | 0.033 | 0.218572331 | 2.071213693 |
| | **2008** | 0.034 | 0.227225131 | 0.466935926 |
| | **2009** | 0.0324 | 0.204288499 | 0.483047242 |
| | **2010** | 0.0565 | 0.293634064 | 1.05704918 |
| | **2011** | 0.0457 | 0.276337115 | 0.601568381 |
| | **2012** | 0.036 | 0.238971865 | 0.894111932 |
| | **2013** | 0.048 | 0.269520412 | 2.072729673 |
| **17.FINA BANK (K) LTD** | **2001** | 0.0088 | 0.06496063 | 0.003441296 |
| | **2002** | 0.011 | 0.083032491 | 0.00394011 |
| | **2003** | 0.01826 | 0.119236884 | 0.01257485 |
| | **2004** | -0.0078 | -0.048220436 | 0.002128631 |
| | **2005** | 0.011 | 0.063146998 | 0.007676887 |
| | **2006** | 0.017 | 0.086148649 | 0.027239621 |
| | **2007** | 0.013 | 0.074933687 | 0.025207469 |
| | **2008** | 0.008 | 0.019090399 | 0.004682366 |
| | **2009** | 0.0018 | 0.009115282 | 0.003995795 |
| | **2010** | 0.0107 | 0.065711462 | 0.007915691 |
| | **2011** | 0.0212 | 0.096071734 | 0.004181305 |
| | **2012** | 0.02 | 0.113019169 | 0.005422454 |
| | **2013** | 0.016 | 0.055327532 | 0.023557682 |
| **18.ABC BANK (K) LTD** | **2001** | 0.011 | 0.079545455 | 0.252591093 |
| | **2002** | 0.011 | 0.078534031 | 0.31284476 |
| | **2003** | 0.0173 | 0.105633803 | 0.697904192 |
| | **2004** | 0.0264 | 0.154761905 | 0.18340249 |
| | **2005** | 0.0201 | 0.15896488 | 0.636084906 |
| | **2006** | 0.021 | 0.143279173 | 2.315367808 |
| | **2007** | 0.028 | 0.165024631 | 2.268672199 |
| | **2008** | 0.033 | 0.162190083 | 0.499452355 |
| | **2009** | 0.0282 | 0.154585153 | 0.659306208 |
| | **2010** | 0.0467 | 0.209687308 | 0.848805621 |
| | **2011** | 0.0412 | 0.219153937 | 0.431348808 |
| | **2012** | 0.029 | 0.200757576 | 0.528864166 |
| | **2013** | 0.029 | 0.235918367 | 0.975752376 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **19.CHASE BANK (K) LTD** | **2001** | 0.0289 | 0.05899705 | 0.002271255 |
| | **2002** | 0.034 | 0.087431694 | 0.002884161 |
| | **2003** | 0.0346 | 0.08492569 | 0.009871257 |
| | **2004** | -0.0431 | -0.127376426 | 0.001855187 |
| | **2005** | 0.0207 | 0.080139373 | 0.006141509 |
| | **2006** | 0.023 | 0.122641509 | 0.021178806 |
| | **2007** | 0.03 | 0.175487465 | 0.0199139 |
| | **2008** | 0.024 | 0.2 | 0.004427437 |
| | **2009** | 0.0242 | 0.172526574 | 0.005509758 |
| | **2010** | 0.0245 | 0.222157434 | 0.010351288 |
| | **2011** | 0.0233 | 0.202761873 | 0.007553325 |
| | **2012** | 0.027 | 0.177185417 | 0.014901866 |
| | **2013** | 0.029 | 0.209696808 | 0.042536959 |
| | | | | |
| **20.GIRO COMM. BANK (K) LTD** | **2002** | 0.006 | 0.078085642 | 0.157604413 |
| | **2003** | 0.007757 | 0.054761905 | 0.44011976 |
| | **2004** | 0.0027 | 0.023201856 | 0.07406639 |
| | **2005** | -0.0009 | 0.008849558 | 0.241273585 |
| | **2006** | 0.01 | 0.086868687 | 0.817188638 |
| | **2007** | 0.007 | 0.0625 | 0.728215768 |
| | **2008** | 0.02 | 0.131578947 | 0.156078861 |
| | **2009** | 0.0263 | 0.17386231 | 0.190910215 |
| | **2010** | 0.062 | 0.38358209 | 0.407962529 |
| | **2011** | 0.0279 | 0.190626979 | 0.213111669 |
| | **2012** | 0.017 | 0.127323944 | 0.269906238 |
| | **2013** | 0.028 | 0.181121227 | 0.564182946 |
| **21.EQUITORIAL COMMERCIAL BANK (K) LTD** | **2001** | 0.0102 | 0.045698925 | 0.002753036 |
| | **2002** | 0.022 | 0.105769231 | 0.003152088 |
| | **2003** | 0.0326 | 0.208695652 | 0.010479042 |
| | **2004** | 0.0342 | 0.137795276 | 0.001763485 |
| | **2005** | 0.0254 | 0.122625216 | 0.006580189 |
| | **2006** | 0.023 | 0.102106969 | 0.020429716 |
| | **2007** | 0.014 | 0.079104478 | 0.019605809 |
| | **2008** | -0.002 | 0.008902077 | 0.00364184 |
| | **2009** | 0.0169 | 0.074380165 | 0.003107841 |
| | **2010** | -0.0032 | -0.075055188 | 0.005480094 |
| | **2011** | 0.0055 | 0.059800664 | 0.031076537 |
| | **2012** | -0.046 | -0.667590028 | 0.025789351 |
| | **2013** | 0.01 | 0.040846098 | 0.080365628 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **22.FIDELITY COMM. BANK (K) LTD** | **2001** | 0.017 | 0.098290598 | 0.158299595 |
| | **2002** | 0.015 | 0.088709677 | 0.197005516 |
| | **2003** | 0.01467 | 0.069230769 | 0.54491018 |
| | **2004** | 0.001 | 0.007633588 | 0.091701245 |
| | **2005** | 0.0084 | 0.066914498 | 0.296108491 |
| | **2006** | 0.01 | 0.06360424 | 0.919337218 |
| | **2007** | 0.014 | 0.102236422 | 0.868257261 |
| | **2008** | 0.017 | 0.139150943 | 0.218510405 |
| | **2009** | 0.0094 | 0.097959184 | 0.21754885 |
| | **2010** | 0.0459 | 0.339575531 | 0.487119438 |
| | **2011** | 0.0279 | 0.193706981 | 0.269761606 |
| | **2012** | 0.009 | 0.075949367 | 0.36038185 |
| | **2013** | 0.025 | 0.150956768 | 0.75873812 |
| **23.ECO-BANK (K) LTD** | **2001** | | | |
| | **2002** | | | |
| | **2003** | 0.004 | 0.059506531 | 0.016766467 |
| | **2004** | -0.0124 | 0.013245033 | 0.003174274 |
| | **2005** | 0.0007 | 0.003108003 | 0.012063679 |
| | **2006** | 0.004 | 0.017186505 | 0.044264385 |
| | **2007** | 0.01 | 0.016235719 | 0.042852697 |
| | **2008** | 0.005 | 0.039586919 | 0.009505203 |
| | **2009** | 0.0713 | -0.370577281 | 0.009581029 |
| | **2010** | 0.007 | 0.024980016 | 0.014430913 |
| | **2011** | 0.0045 | 0.054816825 | 0.010035132 |
| | **2012** | -0.048 | -0.233860343 | 0.011556549 |
| | **2013** | -0.033 | -0.154222766 | 0.025976769 |
| **24.VICTORIA COMMERCIAL BANK (K) LTD** | **2001** | 0.0061 | 0.021505376 | 0.137307692 |
| | **2002** | 0.006 | 0.029227557 | 0.157210402 |
| | **2003** | 0.00929 | 0.042682927 | 0.418113772 |
| | **2004** | 0.0121 | 0.061143984 | 0.070363071 |
| | **2005** | 0.0256 | 0.151245552 | 0.218791274 |
| | **2006** | 0.027 | 0.153184165 | 0.679288055 |
| | **2007** | 0.036 | 0.159817352 | 0.55876556 |
| | **2008** | 0.038 | 0.153342071 | 0.103792442 |
| | **2009** | 0.0422 | -0.161497326 | 0.08857346 |
| | **2010** | 0.05 | 0.194922937 | 0.12147541 |
| | **2011** | 0.0431 | 0.18370607 | 0.05381744 |
| | **2012** | 0.048 | 0.162573674 | 0.060671881 |
| | **2013** | 0.043 | 0.246439873 | 0.107965945 |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **25.PARAMOUNT COMM. BANK (K) KTD** | **2001** | | | |
| | **2002** | | | |
| | **2003** | | | |
| | **2004** | | | |
| | **2005** | 0.0064 | 0.026315789 | 0.003290094 |
| | **2006** | 0.01 | 0.051643192 | 0.013619811 |
| | **2007** | 0.013 | 0.065789474 | 0.014004149 |
| | **2008** | 0.014 | 0.077235772 | 0.002601314 |
| | **2009** | 0.0123 | 0.064516129 | 0.002219886 |
| | **2010** | 0.0635 | 0.321019108 | 0.004871194 |
| | **2011** | 0.0239 | 0.097465887 | 0.002767754 |
| | **2012** | 0.012 | 0.096830986 | 0.0034548 |
| | **2013** | 0.012 | 0.077235772 | 0.006602429 |
| **26.DUBAI BANK (K) KTD** | **2001** | 0.0105 | 0.033783784 | 0.001032389 |
| | **2002** | -0.028 | 0.068627451 | 0.001182033 |
| | **2003** | 0.0115 | 0.030985915 | 0.003772455 |
| | **2004** | 0.027 | 0.08310992 | 0.000670124 |
| | **2005** | 0.0149 | 0.03626943 | 0.002083726 |
| | **2006** | 0.012 | 0.027707809 | 0.00646941 |
| | **2007** | 0.006 | 0.014888337 | 0.005321577 |
| | **2008** | 0.003 | 0.00729927 | 0.000988499 |
| | **2009** | 0.0041 | 0.006479482 | 0.001154341 |
| | **2010** | 0.0018 | 0.003355705 | 0.001583138 |
| | **2011** | 0.009 | 0.019662921 | 0.00070138 |
| | **2012** | -0.012 | -0.026172301 | 0.000790711 |
| | **2013** | 0.005 | 0.008687259 | 0.001407075 |
| **27.CONSOLIDATED BANK (K) LTD** | **2001** | -0.003 | -0.022530329 | 0.017177665 |
| | **2002** | 0.019 | 0.086538462 | 0.022481547 |
| | **2003** | 0.0049 | 0.018867925 | 0.03615566 |
| | **2004** | -0.0155 | -0.125663717 | 0.017211618 |
| | **2005** | -0.0025 | -0.016997167 | 0.060208726 |
| | **2006** | 0.004 | 0.022160665 | 0.195784778 |
| | **2007** | 0.005 | 0.034759358 | 0.170010373 |
| | **2008** | 0.015 | 0.113475177 | 0.037823111 |
| | **2009** | 0.0154 | 0.087378641 | 0.036006555 |
| | **2010** | 0.0246 | 0.116452268 | 0.065882904 |
| | **2011** | 0.0161 | 0.104529617 | 0.032101631 |
| | **2012** | 0.01 | -0.027407407 | 0.046834435 |
| | **2013** | -0.008 | -0.087761675 | 0.065861932 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **28.NATIONAL BANK OF KENYA (K) LTD** | **2001** | -0.0064 | -0.121693122 | 0.248270248 |
| | **2002** | 0.007 | 0.103808033 | 0.380803339 |
| | **2003** | 0.01898 | 0.187558032 | 1.239554318 |
| | **2004** | 0.0124 | 0.145904762 | 1.44 |
| | **2005** | 0.0132 | 0.185541421 | 1.784052125 |
| | **2006** | 0.013 | 0.529868578 | 3.014553015 |
| | **2007** | 0.031 | 0.521240185 | 1.882423998 |
| | **2008** | 0.04 | 0.199903351 | 1.385309278 |
| | **2009** | 0.0413 | 0.185025926 | 0.986467687 |
| | **2010** | 0.0449 | 0.203625378 | 1.099697885 |
| | **2011** | 0.0356 | 0.14784355 | 0.542272379 |
| | **2012** | 0.017 | 0.061613774 | 0.407663741 |
| | **2013** | 0.019 | 0.168995215 | 0.710047847 |
| **29.CO-OP BANK (K) LTD** | **2001** | -0.0143 | -0.403345725 | 0.179623086 |
| | **2002** | 0.002 | 0.070567986 | 0.285602504 |
| | **2003** | 0.005 | 0.073033708 | 0.870473538 |
| | **2004** | 0.0057 | 0.060989982 | 1.325714286 |
| | **2005** | 0.0099 | 0.108187853 | 1.784052125 |
| | **2006** | 0.016 | 0.163058057 | 3.040540541 |
| | **2007** | 0.03 | 0.222611233 | 2.327863902 |
| | **2008** | 0.037 | 0.168500786 | 2.595444333 |
| | **2009** | 0.0326 | 0.181622882 | 1.929249325 |
| | **2010** | 0.0361 | 0.268450185 | 3.221743542 |
| | **2011** | 0.0368 | 0.294106428 | 2.006630674 |
| | **2012** | 0.048 | 0.249559844 | 1.808455743 |
| | **2013** | 0.047 | 0.250448783 | 2.086487806 |
| **30.ORIENTAL COMM. BANK (K) LTD** | **2001** | -0.1319 | 1.253393665 | 0.089473684 |
| | **2002** | -0.066 | -0.039473684 | 0.330969267 |
| | **2003** | -0.10895 | -0.250755287 | 0.670658683 |
| | **2004** | -0.1283 | -0.664948454 | 0.067012448 |
| | **2005** | -0.0327 | -0.071922545 | 0.405778302 |
| | **2006** | -0.031 | -0.074294205 | 1.157683904 |
| | **2007** | 0.088 | 0.178266178 | 1.12033195 |
| | **2008** | 0.025 | 0.05190678 | 0.208105148 |
| | **2009** | 0.0097 | 0.038696538 | 0.190910215 |
| | **2010** | 0.0401 | 0.137082601 | 0.304449649 |
| | **2011** | 0.0383 | 0.117829457 | 0.150122334 |
| | **2012** | 0.018 | 0.067870036 | 0.180647105 |
| | **2013** | 0.025 | 0.091803279 | 0.37125132 |
| | | | | |

| BANK | YEAR | ROA | ROE | TBQ |
|---|---|---|---|---|
| **31.DIAMOND TRUST BANK (K) LTD** | **2001** | 0.0061 | 0.030769231 | 1.23359882 |
| | **2002** | 0.015 | 0.057525611 | 1.266208104 |
| | **2003** | 0.02355 | 0.092065868 | 1.025832706 |
| | **2004** | 0.0165 | -0.029227557 | 2.145223684 |
| | **2005** | 0.194 | 0.150726392 | 1.411052176 |
| | **2006** | 0.026 | 0.155160391 | 1.590888105 |
| | **2007** | 0.028 | 0.109144004 | 2.812009491 |
| | **2008** | 0.031 | 0.128917379 | 3.532775453 |
| | **2009** | 0.0344 | 0.140949555 | 2.424939467 |
| | **2010** | 0.049 | 0.200584795 | 1.936673626 |
| | **2011** | 0.0419 | 0.216766352 | 2.083083832 |
| | **2012** | 0.049 | 0.206210512 | 2.193065406 |
| | **2013** | 0.049 | 0.299763033 | 2.253441296 |
| **32.EQUITY BANK (K) LTD** | **2001** | | | |
| | **2002** | | | |
| | **2003** | | | |
| | **2004** | 0.0305 | 0.10700236 | 1.647954367 |
| | **2005** | 0.0406 | 0.216436637 | 2.476693852 |
| | **2006** | 0.049 | 0.858700591 | 5.719432985 |
| | **2007** | 0.043 | 0.262117048 | 3.642252866 |
| | **2008** | 0.061 | 0.192087215 | 3.335493705 |
| | **2009** | 0.0566 | 0.184818194 | 2.319387577 |
| | **2010** | 0.0695 | 0.26209381 | 3.640982392 |
| | **2011** | 0.0684 | 0.345364796 | 1.732688761 |
| | **2012** | 0.074 | 0.376359205 | 1.670380038 |
| | **2013** | 0.077 | 0.359717482 | 0.365182394 |
| **33.HFCK BANK (K) LTD** | **2001** | 0.029707296 | -0.190862944 | 0.467005076 |
| | **2002** | 0.010812582 | 0.058536585 | 0.583414634 |
| | **2003** | 0.040149188 | 0.047169811 | 1.30754717 |
| | **2004** | 0.038369781 | -0.012863071 | 0.364315353 |
| | **2005** | 0.018327974 | 0.052672956 | 1.261006289 |
| | **2006** | 0.025403168 | 0.056081573 | 4.020393299 |
| | **2007** | 0.010850778 | 0.06362379 | 3.638312586 |
| | **2008** | 0.017388555 | 0.036144578 | 1.228524229 |
| | **2009** | 0.018867925 | 0.057942548 | 1.496439971 |
| | **2010** | 0.015690777 | 0.089227166 | 0.667915691 |
| | **2011** | 0.01806067 | 0.141154329 | 0.597505228 |
| | **2012** | 0.017472743 | 0.133113098 | 0.692337738 |
| | **2013** | 0.018274015 | 0.152411123 | 1.247967265 |

## Appendix 10: Questionnaire Responses

### 1.0 Information on Respondent

1.1 View of cg compared with other banks.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Much better | 11 | 33.3 | 33.3 | 33.3 |
| Slightly better | 12 | 36.4 | 36.4 | 69.7 |
| About the same | 9 | 27.3 | 27.3 | 97.0 |
| Slightly worse | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

1.2 Comparison of corporate governance with those of 5yrs ago.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Much better | 14 | 42.4 | 42.4 | 42.4 |
| Better | 16 | 48.5 | 48.5 | 90.9 |
| About the same | 3 | 9.1 | 9.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

### 2.0 Block Ownership

2.1 The largest shareholder has substantial voting right in bank and holding companies He/she controls.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 28 | 84.8 | 84.8 | 84.8 |
| Agree | 5 | 15.2 | 15.2 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

2.2 Two or more shareholders control the bank.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 14 | 42.4 | 42.4 | 42.4 |
| Agree | 14 | 42.4 | 42.4 | 84.8 |
| Neither agree nor disagree | 5 | 15.2 | 15.2 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

2.3 The bank belongs to same group as bank.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 13 | 39.4 | 39.4 | 39.4 |
| Agree | 18 | 54.5 | 54.5 | 93.9 |
| Neither agree nor disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

2.4 Block ownership in the bank in 2001.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| 81-100% | 14 | 42.4 | 42.4 | 42.4 |
| 61-80 | 7 | 21.2 | 21.2 | 63.6 |
| 41-60% | 6 | 18.2 | 18.2 | 81.8 |
| 21-40% | 1 | 3.0 | 3.0 | 84.8 |
| less than 20% | 5 | 15.2 | 15.2 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

2.5 Block ownership in the bank 2007.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| 81-100% | 10 | 30.3 | 30.3 | 30.3 |
| 61-80% | 10 | 30.3 | 30.3 | 60.6 |
| 41-60% | 7 | 21.2 | 21.2 | 81.8 |
| 21-40% | 2 | 6.1 | 6.1 | 87.9 |
| under 20% | 4 | 12.1 | 12.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

2.6 Block ownership in the bank 2013.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| 81-100% | 11 | 33.3 | 33.3 | 33.3 |
| 61-80% | 10 | 30.3 | 30.3 | 63.6 |
| 41-60% | 5 | 15.2 | 15.2 | 78.8 |
| 20-40% | 2 | 6.1 | 6.1 | 84.8 |
| less than 20% | 5 | 15.2 | 15.2 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

## 3.0 Institutional Holders

3.1 Institutional investors normally disclose voting policies on investment.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 23 | 69.7 | 69.7 | 69.7 |
| Agree | 4 | 12.1 | 12.1 | 81.8 |
| Neither agree nor disagree | 3 | 9.1 | 9.1 | 90.9 |
| Disagree | 1 | 3.0 | 3.0 | 93.9 |
| Strongly disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

3.2 Institutional investors normally disclose the overall corporate governance about their investment.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 21 | 63.6 | 63.6 | 63.6 |
| Agree | 7 | 21.2 | 21.2 | 84.8 |
| Neither agree nor disagree | 1 | 3.0 | 3.0 | 87.9 |
| Disagree | 3 | 9.1 | 9.1 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

3.3 Institutional investors rarely use their vote

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 19 | 57.6 | 57.6 | 57.6 |
| Agree | 7 | 21.2 | 21.2 | 78.8 |
| Neither agree nor disagree | 3 | 9.1 | 9.1 | 87.9 |
| Disagree | 3 | 9.1 | 9.1 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

3.4 institutional investors normally disclose how they manage material conflict of interest.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 17 | 51.5 | 51.5 | 51.5 |
| Agree | 15 | 45.5 | 45.5 | 97.0 |
| Neither agree nor disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

3.5 Institutional investors engage in the banks activities beyond voting.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 15 | 45.5 | 45.5 | 45.5 |
| Agree | 11 | 33.3 | 33.3 | 78.8 |
| Neither agree nor disagree | 5 | 15.2 | 15.2 | 93.9 |
| Strongly disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

**4.0 Board independence:**

4.1 Independent directors are truly independent

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Yes | 23 | 69.7 | 69.7 | 69.7 |
| No | 10 | 30.3 | 30.3 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.2 Why independent directors are not truly independent:
4.2.1 Concern of personal relationship with director?

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 9 | 27.3 | 27.3 | 27.3 |
| Agree | 14 | 42.4 | 42.4 | 69.7 |
| Neither agree nor disagree | 7 | 21.2 | 21.2 | 90.9 |
| Disagree | 1 | 3.0 | 3.0 | 93.9 |
| Strongly disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.2.2 Openly objecting to management agenda is defiance.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 13 | 39.4 | 39.4 | 39.4 |
| Agree | 19 | 57.6 | 57.6 | 97.0 |
| Neither agree nor disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.2.3 CEO and management micro-manage the board.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 9 | 27.3 | 27.3 | 27.3 |
| Agree | 11 | 33.3 | 33.3 | 60.6 |
| Neither agree nor disagree | 10 | 30.3 | 30.3 | 90.9 |
| Disagree | 2 | 6.1 | 6.1 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.3 Who has the authority of dismissal of independent directors?

4.3.1 Board nomination committees autonomously.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 23 | 69.7 | 69.7 | 69.7 |
| Agree | 7 | 21.2 | 21.2 | 90.9 |
| Neither agree nor disagree | 3 | 9.1 | 9.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4 What do you think about the role of board of directors?

4.4.1 Board is a forum of serious discussions.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 22 | 66.7 | 66.7 | 66.7 |
| Agree | 6 | 18.2 | 18.2 | 84.8 |
| Neither agree nor disagree | 5 | 15.2 | 15.2 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.2 Board selects and monitors CEO.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 21 | 63.6 | 63.6 | 63.6 |
| Agree | 6 | 18.2 | 18.2 | 81.8 |
| Neither disagree nor agree | 3 | 9.1 | 9.1 | 90.9 |
| Disagree | 1 | 3.0 | 3.0 | 93.9 |
| Strongly disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.3 Board revises key executive and directors' remuneration.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 9 | 27.3 | 27.3 | 27.3 |
| Agree | 18 | 54.5 | 54.5 | 81.8 |
| Neither agree nor disagree | 4 | 12.1 | 12.1 | 93.9 |
| Disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.4 Board reviews potential conflict of interest and related party transactions.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 8 | 24.2 | 24.2 | 24.2 |
| Agree | 22 | 66.7 | 66.7 | 90.9 |
| Neither agree nor disagree | 1 | 3.0 | 3.0 | 93.9 |
| Disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.5 Board ensures integrity of banks financial reporting.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 14 | 42.4 | 42.4 | 42.4 |
| Agree | 16 | 48.5 | 48.5 | 90.9 |
| Neither agree nor disagree | 2 | 6.1 | 6.1 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.6 Board ensures proper disclosure and communicates with stakeholders.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 10 | 30.3 | 30.3 | 30.3 |
| Agree | 22 | 66.7 | 66.7 | 97.0 |
| Neither agree nor disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.7 Board ensures effectiveness of corporate governance.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 11 | 33.3 | 33.3 | 33.3 |
| Agree | 20 | 60.6 | 60.6 | 93.9 |
| Neither agree nor disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.8 The board has the strongest say in removing a non performing CEO?

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 21 | 63.6 | 63.6 | 63.6 |
| Agree | 7 | 21.2 | 21.2 | 84.8 |
| Neither agree nor disagree | 4 | 12.1 | 12.1 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

4.4.9 How good do you think access to information is for independent directors? In your bank?

-Board of directors have access to the banks record of account any time

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 7 | 21.2 | 21.2 | 21.2 |
| Agree | 20 | 60.6 | 60.6 | 81.8 |
| Neither agree nor disagree | 4 | 12.1 | 12.1 | 93.9 |
| Disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

-The board of directors gets enough information before the board meeting.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 21 | 63.6 | 63.6 | 63.6 |
| Agree | 11 | 33.3 | 33.3 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

-Board of directors are permitted to access services of outside professionals at banks expense.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 7 | 21.2 | 21.2 | 21.2 |
| Agree | 12 | 36.4 | 36.4 | 57.6 |
| Neither agree nor disagree | 13 | 39.4 | 39.4 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

-What do you think about financial compensation of independent directors**?**
-Adequate.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 17 | 51.5 | 51.5 | 51.5 |
| Agree | 11 | 33.3 | 33.3 | 84.8 |
| Neither agree nor disagree | 4 | 12.1 | 12.1 | 97.0 |
| | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

5.0 How serious is your banks concern about potential director liability?

5.1 Very serious.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 22 | 66.7 | 66.7 | 66.7 |
| Agree | 5 | 15.2 | 15.2 | 81.8 |
| Neither agree nor disagree | 2 | 6.1 | 6.1 | 87.9 |
| Disagree | 3 | 9.1 | 9.1 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

## 6.0 Board Size

6.1 Board size 2001.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| More than 10 | 3 | 9.1 | 9.4 | 9.4 |
| 1-10 | 8 | 24.2 | 25.0 | 34.4 |
| 1-8 | 9 | 27.3 | 28.1 | 62.5 |
| 1-6 | 13 | 36.4 | 37.5 | 100.0 |
| Total | 33 | 97.0 | 100.0 | |

6.2 Board size 2007.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| More than 10 | 5 | 15.2 | 15.2 | 15.2 |
| 1-10 | 6 | 18.2 | 18.2 | 33.3 |
| 1-8 | 6 | 18.2 | 18.2 | 51.5 |
| 1-6 | 16 | 48.5 | 48.5 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

6.3 Board size 2013.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| More than 10 | 3 | 9.1 | 9.1 | 9.1 |
| 1-10 | 11 | 33.3 | 33.3 | 42.4 |
| 1-8 | 7 | 21.2 | 21.2 | 63.6 |
| 1-6 | 11 | 33.3 | 33.3 | 97.0 |
| 1-4 | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

6.4 Justification for the above board size:

6.4.1 Need for professional diversification in decision making

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 26 | 78.8 | 78.8 | 78.8 |
| Agree | 4 | 12.1 | 12.1 | 90.9 |
| Neither agree nor disagree | 2 | 6.1 | 6.1 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

6.4.2 Check CEO excesses.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 5 | 15.2 | 15.2 | 15.2 |
| Agree | 20 | 60.6 | 60.6 | 75.8 |
| Neither agree nor disagree | 6 | 18.2 | 18.2 | 93.9 |
| Disagree | 1 | 3.0 | 3.0 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

**7.0 Bank Performance**

What is your take of the following performance measures?

7.1 Bank has had good improvement in ROA for last 5 years.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 9 | 27.3 | 27.3 | 27.3 |
| Agree | 11 | 33.3 | 33.3 | 60.6 |
| Neither agree nor disagree | 10 | 30.3 | 30.3 | 90.9 |
| Disagree | 3 | 9.1 | 9.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

7.2 Bank has better ROA than industry average.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 6 | 18.2 | 18.2 | 18.2 |
| Agree | 14 | 42.4 | 42.4 | 60.6 |
| Neither agree nor disagree | 11 | 33.3 | 33.3 | 93.9 |
| Disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

7.3 Bank has had good improvement in roe for last 5 years.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 13 | 39.4 | 39.4 | 39.4 |
| Agree | 14 | 42.4 | 42.4 | 81.8 |
| Neither agree nor disagree | 5 | 15.2 | 15.2 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

7.4 Bank has better roe than industry average

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 12 | 36.4 | 36.4 | 36.4 |
| Agree | 13 | 39.4 | 39.4 | 75.8 |
| Neither disagree nor agree | 7 | 21.2 | 21.2 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

7.5 Bank has had good improvement in TBQ ratio for last 5yrs.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 9 | 27.3 | 27.3 | 27.3 |
| Agree | 8 | 24.2 | 24.2 | 51.5 |
| Neither agree nor disagree | 14 | 42.4 | 42.4 | 93.9 |
| Disagree | 2 | 6.1 | 6.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

7.6 Bank has better TBQ ratio than industry average

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 9 | 27.3 | 27.3 | 27.3 |
| Agree | 9 | 27.3 | 27.3 | 54.5 |
| Neither agree nor disagree | 14 | 42.4 | 42.4 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

8 .0 Extend to which you agree with the following statements as to why banks acquire large size.

8.1 To reduce risk of failure.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 10 | 30.3 | 30.3 | 30.3 |
| Agree | 9 | 27.3 | 27.3 | 57.6 |
| Neither agree nor disagree | 9 | 27.3 | 27.3 | 84.8 |
| Disagree | 1 | 3.0 | 3.0 | 87.9 |
| Strongly disagree | 4 | 12.1 | 12.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

8.2 Take advantage of economies of scale.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 19 | 57.6 | 57.6 | 57.6 |
| Agree | 14 | 42.4 | 42.4 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

8.3 Due to recent development in information technology.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 7 | 21.2 | 21.2 | 21.2 |
| Agree | 18 | 54.5 | 54.5 | 75.8 |
| Neither agree nor disagree | 5 | 15.2 | 15.2 | 90.9 |
| Disagree | 3 | 9.1 | 9.1 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

8.4 Wider coverage for customer satisfaction.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 15 | 45.5 | 45.5 | 45.5 |
| Agree | 17 | 51.5 | 51.5 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

**9.0 General Corporate Governance Position in the Bank**

9.1 What enhances corporate governance in your bank?

9.1.1 Making internal corporate governance work better.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 23 | 69.7 | 69.7 | 69.7 |
| Agree | 10 | 30.3 | 30.3 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

9.1.2 Relying on efficacy of external corporate governance mechanisms.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 7 | 21.2 | 21.2 | 21.2 |
| Agree | 16 | 48.5 | 48.5 | 69.7 |
| Neither agree nor disagree | 8 | 24.2 | 24.2 | 93.9 |
| Disagree | 1 | 3.0 | 3.0 | 97.0 |
| Strongly disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

9.1.3 Strictly adhering to accounting standards, audit and disclosure.

| | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|
| Strongly agree | 17 | 51.5 | 51.5 | 51.5 |
| Agree | 12 | 36.4 | 36.4 | 87.9 |
| Neither agree nor disagree | 3 | 9.1 | 9.1 | 97.0 |
| Disagree | 1 | 3.0 | 3.0 | 100.0 |
| Total | 33 | 100.0 | 100.0 | |

**Appendix 11: Commercial Banks Corporate Governance Data Base 2001-2013**

1. Weighted average interest on insider loans.
2. Auditors' remuneration.
3. Directors emoluments.
4. Number of directors.
5. Number of executive directors.
6. Number of non executive directors.
7. Proportion of non-executive directors.
8. Board audit committee existence.
9. Non executive directors in audit committee.
10. Non executive directors in credit committee.
11. Corporate governance statement.
12. Executive Chairman.
13. Shareholder (% controlled by three top shareholders).
14. Board credit committee.

**(Source: Banks Annual financial reports 2001-2013)**

## Appendix 12: Determinants of Commercial Bank Performance

**Factors determining commercial banks performance**

1. **Internal factors:**
   - -Capital size.
   - -Size of deposit liabilities.
   - -Size and composition of credit portfolio.
   - -Interest rate policy.
   - -Labour productivity.
   - -Risk level.
2. **Bank specific factors:**
   - -Capital adequacy.
   - -Asset quality.
   - -Management efficiency.
   - -Earning ability.
   - -Liquidity.
3. **External/Macroeconomic factors:**
   - -Macroeconomic environment.
   - -Gross domestic product.
   - -Inflation.
   - -Interest rate and political stability.

**(Source: Imdadz et. al 2011 & Andreas and Gabrielle, 2009).**

**Appendix 13: Market Share and Interest Income of Top Six Banks in Kenya**

| Year | Market size % | Interest income % |
|---|---|---|
| 2008 | 58.85 | 31.4 |
| 2009 | 55.54 | 17.9 |
| 2010 | 55.60 | 66.28 |
| 2011 | 54.64 | 70.54 |
| 2012 | 52.98 | 77.30 |
| 2013 | 51.85 | 76.20 |

**(Source: The Bank Survey, 2013).**

**Appendix 14: Top Six Banks: Total Assets, Shareholders Funds and Profit Before Tax**

| **Year** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** |
|---|---|---|---|---|---|---|
| Total assets (%) | 56 | 55 | 56.23 | 54.2 | 52.9 | 51.4 |
| Shareholders' funds (%) | 55.9 | 54.4 | 56.8 | 55.3 | 56 | 55.4 |
| Profit before tax (%) | 68.3 | 70.5 | 64.4 | 64.2 | 67.8 | 62.76 |

**(Source: The Bank Survey, 2013).**

## Appendix 15: Letter of Introduction

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Department of Business and Social Sciences

**KAREN CAMPUS**

JKU/03/COD/BSS/IK

**TO WHOM IT MAY CONCERN**

Dear Sir/Madam

**SUB: JOSHUA MATANDA WEPUKHULU HD433-C002-2257/2011**

This is to certify that the above named is a bona fide student of Jomo Kenyatta University of Agriculture and Technology Karen Campus. He is pursuing a PhD degree in business Administration.

I wish to confirm that he has successfully completed his course work and he is currently collecting data to enable him finalize his thesis work. His topic of study is: Relationship between corporate governance and performance of commercial banks in Kenya. Joshua is hard working and honest student with great capabilities.

Any assistance accorded to him will be highly appreciated. Should you have further enquiries please feel free to contact the undersigned.

Thank you,

**Dr. Agnes Njeru**
**Coordinator, postgraduate studies**