

**EFFECTS OF CORPORATE GOVERNANCE ON LOAN PERFORMANCE  
OF COMMERCIAL BANKS IN KENYA**

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**DECLARATION**

This project is my original work and has not been submitted for examination in any other university or institution of higher learning.

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## **DEDICATION**

I dedicate this research project to my family members. To my late dad Charles and mother Abigail you do things in small ways but in a mighty way and I will always cherish every bit of support you accorded to me. To my husband George and sons Barzillai and Brayden you mean everything to me but without your love, patience and support, all this would have not been successful.

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## DEFINATION OF TERMS

**Agent** – is any individual or corporation (party) hired to work and make decisions on behalf of another in order to maximize returns to the party that hired it.

**Corporate Governance-** Is a technique that is employed in institutions by the help of systems, policies and people in order to ensure the satisfaction of the shareholders' desires.

**Loan Performance-** A Bank's ability to generate new resources from the credits offered to the customers over a given period of time. Performance is gauged by Non-performing Loans .

**Performance-** It's the reflection of the way in which the resources of a Company (bank) are used in the form that enables it to achieve its objectives.

**Principal-** Any party that hires another to work for it and make decisions on its behalf with an aim of maximizing returns for it.

## **ABBREVIATIONS**

**AS**-Audit Structure

**BS**- Board Structure

**CACG**-Common wealth Association for Corporate Governance

**CBK**- Central Bank of Kenya

**CCG**-Corporate governance of Kenya

**CEO**- Chief Executive Officer

**KBA**- Kenya Bankers Association

**KDIC**-Kenya Deposit Insurance Corporation

**MBA**- Master of Business Administration

**NPA**-Non -Performing Assets ratio.

**NPLs**-Non-Performing Loans

**OECD**-Organization for Economic Co-operation and Development

**PSICG**-Private Sector Initiative for Corporate Governance

**ROA**-Return On Assets

**ROE**-Return On Equity

**ROK** –Republic of Kenya

## **ABSTRACT.**

The study examined the Corporate Governance variables and Loan Performance of commercial banks in Kenya. The study aimed at establishing the effects of corporate governance variables (BS, AS and CEO duality) on Loan Performance of commercial banks in Kenya. Descriptive research design was used in this study. The population involved in this study was all the 43 commercial banks in Kenya. A sample of 43 commercial banks was used to obtain sample representation of the entire population this is because the sample size is manageable. Both Primary and secondary data were obtained by administering questionnaires to the CEOs of the banks and also informational data was obtained from the published annual reports and company sources spanning five years (2010-2014). Karlpearsons Correlation Coefficient and Multiple Regression Analysis were used to determine the magnitude of the relationship between corporate governance variables and loan performance. Stata version 13 program was also used in analyzing the data. The BS has a positive relation on the loan performance levels of the commercial banks meaning that bigger boards, lower frequency of the board meetings and less number of independent directors tend to reduce the level of the INPLs hence leading to better loan performance levels for the banks however this was not significant for this study. AS has a significantly negative relation on the loan performance levels in that; as the AS increases, it reduces the INPLs also higher frequency of the meetings and the increase in the number of independent auditors reduces the INPLs leading to better loan performance. CEO duality shows a positive relation to the INPLs in that the separation of the CEOs office and that of the chair leads to a decrease of the INPLs thus resulting to better loan performance. From the R square value of the regression test findings, corporate governance factors (BS, AS and CD) account for 86% of the loan performance of commercial banks. The study then recommends that the banks need to avoid overloaded agenda in their committees and rather emphasis on the quality of the agenda. More efforts also need to be employed at increasing the year size, looking at other corporate governance variables like; board expertise, policy formulation and implementation and board tenure not forgetting the use of other financial performance measures like ROE and ROA.

## CHAPTER ONE:

### INTRODUCTION

#### 1.1 Background information

Corporate governance has been an issue of global concern long before now (Akpan & Riman, 2012). Studies in line to corporate governance matter have majorly been carried out in developed economies mostly in the United States of America and the United Kingdom with few studies being done in Africa and specifically in Kenya (Mangunyí, 2011). The global economic impact of financial crisis and the alleged role played by corporate governance symbolizes the need for more empirical research on the functions of corporate governance at banks (Grove, *et al.*, 2011). The absence of good corporate governance is a major cause of failure of many well performing companies and the existing literature generally support the position that good corporate governance has a positive effect on organization performance (OECD, 2009). Governance of banks in that case becomes even more evident considering their role of financial intermediation in the developing economies and more so the Commercial banks that are the key providers of funds to a variety of enterprises (Akpan & Riman 2012) .Poor banking systems can therefore have colossal costs on the developing countries of up to 15% of their GDP (Simpson ,2004). The idea of corporate governance has consequently attracted a good deal of public concern in the current years because of its apparent importance on the economic health of corporation and society in general (Obeten, *etal.*, 2014).

Corporate governance has been defined as the mechanisms through which stakeholders (shareholders, creditors, employees, clients, suppliers, the government and the society at general) monitor the management and insiders to safe guard their own interests ( Adams & Mehran ,2003). Shareholders delegate their duties to the management team and they in return expect the management to act in the best interest of them thus improving investor confidence, economic efficiency and growth (Fanta, *et al.*, 2013). According to Mang´unyí (2011), corporate governance is an internal system that comprises of processes, policies and people that serve the needs of shareholders by controlling and directing management actions with good business savvy, objectivity, accountability and integrity. Corporate governance then deals with problems of

conflict of interest, designs ways to prevent corporate misconduct and it aligns the interest of stakeholders using incentive mechanisms (Wanyama & Olweny, 2013).

A variety of corporate governance frame works have been developed and adopted in different parts of the world. Mulili and Wong (2010), suggests that countries that followed civil law such as France, Germany and Italy had corporate frameworks that majorly focused on stakeholders while countries that had a tradition of common law like Australia, United Kingdom and United State of America concentrated on the frameworks that focused on shareholders. The improvement of corporate governance practices is widely recognized as one of the most important elements in strengthening the foundation for the long term economic performance of countries and corporations (Ibrahim, *et al.*, 2010).

In this brave new world, one main important thing remains unchanged, the need to have sound resident banking systems and the strong banks with good corporate governance practices (Crespi, *et al.*, 2002). Corporate governance in the banking industry requires judicious and prudent management of resources and the preservation of resources (assets) of the corporate firm ensuring ethical and professional standards and the pursuit of corporate objectives and goals. It also seeks to ensure customer satisfaction, high employee morale and the maintenance of market discipline, which strengthens and stabilizes the banks' performance (Obeten *et al.*, 2014). Poor corporate governance of banks can drive the market to withdraw its confidence in the ability of a bank then it leads to economic crisis in a country and invite systematic risks (Garcia-Marco and Robles-Fernande, 2008).

### **1.1.1 Corporate Governance in Kenya.**

Like other countries, corporate governance variables in Kenya have also gained prominence (Ekadah & Mboya, 2011). This has been caused partly by corporate failure or poor performance of public and private organizations (Barako, *et al.*, 2006). According to the private sector initiative for corporate governance (PSICG), the common wealth heads of government meeting that was held on October 1997 led to the establishment of the common wealth association for corporate governance (CACG). The CACG guidelines and principles were to be used as a bench mark to all the common wealth countries (PSICG, 1999).

Corporate Governance in Kenya started in 1999 when the centre for corporate governance Kenya developed a frame work that was voluntary for companies to adopt (Wanyama & Olweny, 2013). Consultative corporate sector seminars held in November 1998 and March 1999 settled that a private sector initiative for corporate governance be established to: formulate and develop a code of best practice for corporate governance in Kenya; Explore ways and means of facilitating the establishment of a national apex body (National Corporate Sector Foundation) to promote corporate governance in Kenya with the initiatives in East Africa (Otieno , *et al.*, 2015).

In the year 2000, the Capital markets authority took up the corporate governance frame work as a draft for all the listed companies in Kenya and it made it a must for the listed companies to put it into practice, (Wanyama, 2011). The idea of corporate governance in Kenya is gaining momentum, this is due to the poor history of the governance systems in the banking sector and they include; conflict of interest and insider lending which caused most of the financial institution to be put under statutory management as others collapsed, weaknesses in the internal control systems, supervisory and regulatory systems and weak corporate governance practices (CCG, 2004). Section 10 (2) of the Kenya constitution therefore attributes the pillars of corporate governance that need to be observed by the management teams. They include; transparency, accountability, integrity and fairness, efficiency and effectiveness, responsibility and transparency (ROK, 2010).

Owing to increased interest in corporate governance observance by stakeholders and regulatory bodies of corporation in Kenya, the area has been of ardent interest to scholars ( Kalungu, 2014). Measures have been put by institutions such as the capital markets authority and centre for corporate governance to defend the cause of good corporate governance. However, despite all the measures the problem of corporate governance still remains unsettled since the relevant facts from empirical studies are still few and far apart (Mang`unyi, 2011). The measures include: Development of prudential regulations, amendment of the Banking Act - for example: Section 24 (5) that gives the Central Bank ability to arrange trilateral meetings with an institution and its auditor, increased interaction with other regulatory authorities, directors and external auditors. Corporate governance in Kenya is now gaining a little level of recognition with very little work in the area even in the well regulated institution and sectors.

### **1.1.2 Loan performance**

Performance may be defined as the way in which the resources of a company are used in order to achieve its objectives and goals. Loan performance therefore refers to how well an organization is performing in terms of credit. Performance of the organization is also the way in which an organization achieves its intended results, (Namisi, 2002). Banks offer credits to its customers with an expectation that they repay within the stipulated time however sometimes the customers do not honor their promises and therefore they fail to repay so this uncollectible loans are referred to as non-performing loans. According to the International monetary fund, NPLs are those loans that have not been repaid over duration of more than 90 days.

### **1.1.3 Relationship between Corporate Governance and Loan performance**

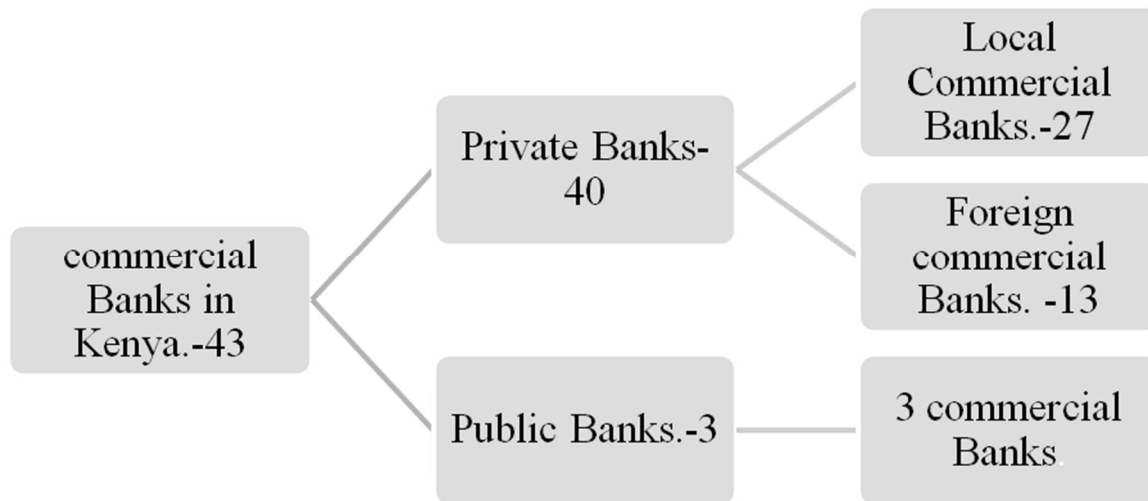
According to Mang'anyi (2011), corporate governance is an internal system that comprises of processes, policies and people that serve the needs of shareholders by controlling and directing management activities with good business savvy, integrity, objectivity, integrity and accountability. Corporate governance then deals with problems of conflict of interest, designs ways to prevent corporate misconduct and it aligns the interest of stakeholders using incentive mechanisms (Wanyama & Olweny, 2013). This then brings about the agency and stakeholders theories that govern the management systems in most institutions.

Masibo, (2005) researched on Board Governance and firm financial performance of selected state owned corporations listed on Uganda Securities Exchange and obtained a positive direct and indirect link between Board Governance and Firm financial Performance. Kibugi, 2008 conducted a study on the effects of corporate governance on the financial performance of commercial banks in Kenya and found out that corporate governance practices (risk management, regulatory framework and bank transparency) affects the financial performance of the Kenyan commercial banks. Akpan and Riman, 2012 conducted a study on corporate governance and Bank performance in Nigeria between 2005 and 2008 and found out that corporate governance affects positively the financial performance of the banks.



#### 1.1.4 Commercial Banking in Kenya.

Currently in Kenya there are a total of 43 licensed commercial banks and 1 Mortgage Company out of which 30 are locally owned and 13 are foreign owned. Of the 30 locally owned, 3 of them have significant share holding by the government (KBA, 2015). Figure1.1 then clearly shows the classification of commercial banks in Kenya.



**Figure1.1.**Classification of Commercial Banks in Kenya

Source: Central Bank of Kenya, 2015

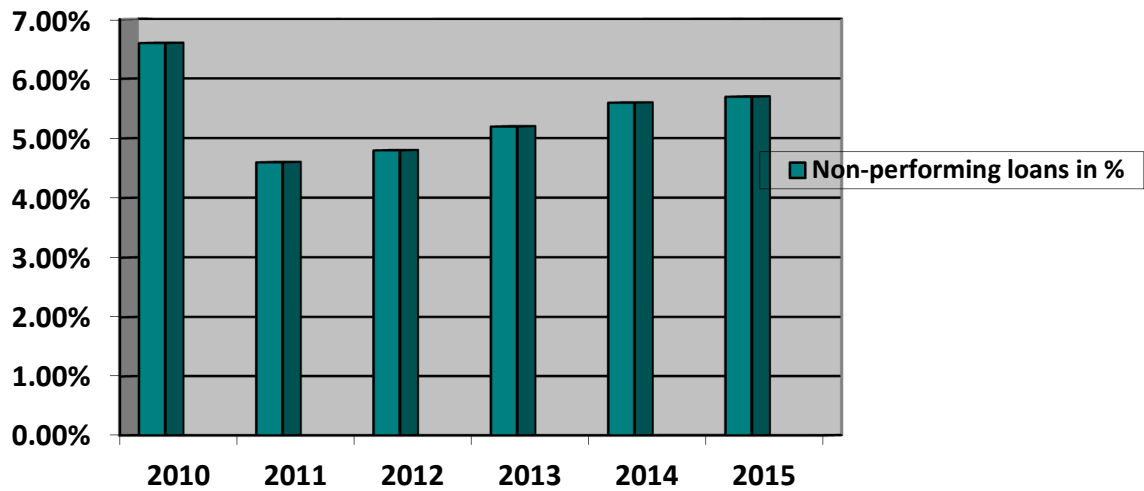
According to the Centre for Corporate Governance of Kenya (CCG,2004), focus on corporate governance in the financial sector is essential mostly because the banking sector became highly exposed to inquiry by the public and many lessons were learnt since most of the risks involved including adverse publicity were brought about by collapsing in governance and stakeholder relations. Corporate governance systems in Kenya were highly influenced by two factors: the government's relaxed rules that governed issuance of licenses to banks in 1982 and the privatization procedures that began in the 1980's and gained momentum in the 90's. This led to the development of many banks that did not practice proper corporate governance structures leading to poor governance and management culture in the banking sector (Mwangi, 2002).

From 1984 to 1987 seven of the Kenyan banks were placed under liquidation. This was due to the system weaknesses in the governance and management processes and the internal controls. Some of the banks that collapsed include; Continental Bank of Kenya, Continental Credit Finance Ltd, Euro bank, Trust Bank, and Daima Bank collapsed. The Government then formed Consolidated Bank by merging seven banks that had collapsed (Nambiro, 2007). The CCG, (2004) gave the following reasons as being the main contributors to the collapse of the banking institutions in Kenya; lack of internal controls and weak corporate governance practices, conflict of interest and insider lending, weaknesses in supervisory and regulatory systems and poor risk management tactics. Appendix 4 clearly indicates some of the banks that have been liquidated or put under receivership from the time banking begun in Kenya.

According to the CBK 2006, changes were made in the banking act in order to control the banking instability due to the problems that were experienced earlier. This was for example, through raising the capital requirements and the creation of the Depositors Protection Fund. In spite of the efforts made to streamline the banking industry, many banks have been liquidated or put under receivership (Kibugi, 2008). On August 2015, the Kenya Deposit Insurance corporation report to the central Bank of Kenya showed that the Dubai bank in Kenya had been experiencing liquidity and capital deficiencies and therefore it ordered for its liquidation (KDIC, 2015). According to the Central Bank of Kenya's statement on market speculation on September 2015, the Imperial Bank Limited was also placed under management by the Central Bank of Kenya for a period of 12 months due to the fraudulent activities done by the bank and shareholders proposed the change of board of directors and the senior management as well as the recovery and collateralization of the fraudulent loans (CBK, 2015).

#### **1.1.5 Loan Performance of Commercial Banks in Kenya.**

The CBK report of 2015 indicated that NPLs as a financial indicator was growing faster since late 2010 to 2015 also the Cytonns financial report 2015; on the banking industry suggests that there is an increase in the non-performing loans that is risky to the banking industry. Figure 1.2 shows the NPLs to total loans as per the Central bank of Kenya.



**Figure 1.2 NPLs to total loans ratio.**

Source: Central bank of Kenya.

From figure 1.2, it can be seen clearly that in the year 2010 there was an increase in the percentage of the non performing loans which was above 6%. In 2011, the percentage was below 5% same case to 2012 but in 2013 there was a gradual increment in the percentage levels proceeding to the year 2014 and 2015. This is a clear indication of some loan defaults by some of the borrowers across all commercial banks in Kenya which is a risky state to the banking industry as well as to the economy of the country that can result to a credit crunch.

Another survey by the Cytonn investment 2015 on ten commercial banks indicated that only four banks had performed better while others had a rating of below five indicating that they were not performing better in terms of the NPLs. According to Cytonn investment 2015, the bank rating assigns a value of 1 for the best performing bank and a value of 11 for the worst. Diamond trust bank had the least non- performing loans to total loans ratio of 1.43% while National Bank had the highest non- performing loans at 9.95%.

It is believed that good governance generates investor goodwill and confidence. Again, poorly governed firms are expected to be less profitable (Otieno, 2012). In Kenya the commercial Banks dominate the financial sector and in any country where the financial sector is subjugated by

commercial banks, any failure in the sector has an immense implication on the economic growth of the country (Ongore & Kusa, 2013).

## **1.2 Statement of the Problem**

As it can be seen in the background, commercial banks have performance issues as depicted by the NPLs. NPLs have been increasing instead of decreasing. The purpose of this study is to assess the effects of corporate governance on loan performance of commercial banks in Kenya as proxied by NPLs.

Corporate governance is not well emphasized in most organizations; (Kihumba, 2000). Many researchers have however examined the relationship between a variety of governance mechanisms and firm performance but the outcomes are mixed. Some examine only the effect of one governance mechanism on performance like Linyiru, 2006 and Manguyi ,2011 while Otieno, 2012 looked at the influence of several mechanisms on performance .Others have concentrated on the corporate governance and financial performances on; state corporations, cooperative societies, as well as companies listed in the Nairobi Stock Exchange in Kenya Muriithi (2011); Awino ( 2011); Wanyama and Olweny (2013), Otieno, Mugo, Njeje and Kimathi( 2015).

Researchers such as Miringu and Muoria (2011), Mangunyi (2011) and Ongore and Kusa (2013) Conducted a study on the effects of ownership structure on corporate governance and performance in the commercial Banks and they focused mainly on the macroeconomic factors like inflation and GDP. Others like (Kibugi (2008) and Otieno (2012) looked at the effects of corporate governance on the financial performance of commercial banks in Kenya and they concentrated on the specific variables like financial disclosure and risk management.

It is against this background that the study intends to carry out an investigation on the effects of corporate governance on the Loan performance of commercial Banks in Kenya since none of the studies has looked on this area hence bridging the gap that exists by adding more empirical studies to the local arena.

### **1.3 Research Objectives**

#### **1.3.1 General Objective**

The main objective in this study was to investigate the effects of corporate governance on the loan performance of commercial banks in Kenya.

#### **1.3.2 Specific Objectives.**

- (i) To evaluate the effect of the board structure on the loan performance of the commercial banks in Kenya.
- (ii) To determine the relationship between the audit structure and loan performance of commercial banks in Kenya.
- (iii) To assess how CEO duality affects the loan performance of commercial banks in Kenya.

#### **1.3.3 Research Questions**

- (i) What is the effect of board structure on the loan performance of the commercial banks in Kenya?
- (ii) What is the relationship between the audit structure and the loan performance of the commercial banks in Kenya?
- (iii) How does CEO duality affect the loan performance of commercial banks in Kenya?

### **1.4 Significance of the Study**

The study is to help the commercial banks to enhance better understanding on how corporate governance affects the Loan performance of banks and help them make better decisions on how to implement good corporate governance practices that are in line with the financial performances of banks. The government is also to benefit in a manner that it can formulate and implement policies that are to promote good corporate governance in the other arms of the government. The researchers can as well use the study as a basis for further studies. It's to benefit the policy makers in the formulation and implementation of policies on Loan performance.

### **1.5 Scope of the Study**

The study targeted all the 43 commercial banks whose head quarters are in Nairobi town.

## **1.6 Assumption of the Study**

The study assumed that all the respondents were literate. It also assumed that the chief executive officers were to be found and be cooperative in giving the required information.

## **1.7 Justification of the Study**

The research was selected for study due to the existing gap. This is because it had been found out that most of the financial institutions collapsed due to poor corporate governance mechanisms. With good corporate governance then the banking industry is assured of better Loan performance.

So the study looks at some of the corporate governance variables like the board structure, the audit structure and the CEO duality and thereafter it examines on how they affect the Loan performance of the commercial banks. The findings have highlighted the important areas that the banking industry needs to look at in order to improve on the loan performance of the commercial banks.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

The chapter reviews various literature related to the area of study. It covers board structure, audit structure, CEO duality and other issues on corporate governance and explains on how they affect the loan performance of the commercial banks of Kenya.

## **2.2 Theoretical frame work.**

The theoretical framework has been drawn from the following theories; agency theory, stakeholders' theory and stewardship theory.

### **2.2.1 Agency theory.**

The Agency theory was first discovered by Stephen Ross and Barry Mitnick in the year 1973. (Barry Mitnick, 2006). Agency theory has been widely used as a means of explaining various corporate issues. The theory is based on the existence of separation of ownership and control in large corporations where the managers (agents) are hired to work and make decisions on behalf of the owners (principals) in order to maximize returns to the shareholders (Jensen & Meckling, 1976).

Conflict of interest may arise between the agent and the principal when the agent fails to act in the best interest of the principal instead acts to maximize their own values. (Jensen *et al.*,1976).This conflicts of interest occurs due to variations in their preferred level of managerial effort, their attitudes towards risk and their time horizon which may lead to disagreement in the goals of managers and shareholders ( Bozec & Bozec, 2007). This then explains on the disadvantages of the theory in that, it brings about the agency costs were some monetary expenditures are incurred by the organization, adverse selection, and moral hazard that end up affecting the financial performance of an organization.

Several mechanisms have been suggested to reduce the agency problem in the firm for example; dividend mechanism that mitigates the managerial goals to make an over investment decision which is financed by international free cash flow, Managerial incentives mechanism that compensates managerial hard work to serve the owners' interest, bonding mechanism; it reduces managerial moral hazards which potentially occurs when they are not restricted by bond contract and insolvency risk. Other owners' efforts to ease agency cost of equity, potentially created by moral hazard manager comprise of ; the interaction of owners to choose trustworthy board of

directors, direct intrusion by shareholders, the threat of firing, and the threat of takeovers of the organization (Sanda *et al.*, 2005).

The theory is of more benefit to this research this is because all the conflicts that exists between the managers and the shareholders need to be eliminated and this can only happen if the directors and the top management team practices or puts into action the pillars of good corporate governance which include; accountability, integrity and fairness, responsibility and transparency.

### **2.2.2 Stakeholders theory.**

Stakeholders' theory emerged from the management discipline and steadily developed to incorporate corporate accountability to a wider range of stakeholders. The stakeholders' theory maintains that managers in organizations are not only responsible for the shareholder's interests but also for the benefit of other stakeholders (suppliers, customers, employees and business partner) this makes it superlative to the agency theory where managers are predominantly responsible for satisfying the interest of shareholders only .( Abdullah & valentine, 2009).

The most important issue in corporate governance is on whether it focuses exclusively on protecting the interest of equity holders in the corporation and dealing with the problem of stakeholders (Macey and Ohara, 2003). The performance of a firm is not and should not be measured only by gains to its stakeholders other major issues such as flow of information from senior management to lower ranks, interpersonal relations and working environments should also be considered (Jensen, 2001).

The theory faces some of the limitations. The impossibility of a company's management pleasing all stakeholders simultaneously since their interests vary from one group to another. This is due to the disagreements and dissatisfaction that arises due to the contentious issues surrounding high returns on investments and high costs. Some stakeholders may also not be able to influence the decisions of the organization this is because of the differences in power levels and spheres of influence within the organization (Matt Mc Gew, 2015).The theory then becomes important to this research in that the top management has to ensure better relationships with all the stakeholders in order for the organization to have better loan performances.



### **2.2.3 Stewardship theory:**

The stewardship theory, on the other hand, originates from sociology and psychology. The stewardship theory maintains that managers are not motivated by individual goals but rather they are stewards, whose motives are aligned with the objectives of their (principals) shareholders (Abdullah & valentine, 2009); as opposed to the agency theory which claims that conflict of interest between managers and shareholder is inevitable unless appropriate structures of control are put in place to align the interests of managers and shareholders (Jensen& Meckling, 1976).

The stewardship perspective suggests that stewards (managers) are contented and motivated when organizational achievements are attained even at the expense of the Stewards' personal goals (Abdullah & Valentine, 2009). While the agency theory argues that the interest of shareholders is to be protected by separating the positions held by both the CEO and the chairperson, the stewardship theory suggests that shareholder interests is to be maximized by assigning the posts of board chair and CEO to an individual in order to give the CEO more autonomy and responsibility as a steward in the organization (Donaldson, 1991).The theory then becomes relevant to the research since the top management acts as stewards to their shareholders and they have to incorporate the pillars of good corporate governance for them to ensure better loan performance for the organization.

## **2.3 Empirical literature**

### **2.3.1 Corporate governance frame work and variables.**

It's a set of relationship between a company's' management, its board, its shareholding and other stakeholder (OECD principles of corporate governance 1999).Corporate governance is a system that provides the required principles and guidelines to the board of directors for them to effectively achieve the required objectives and goals of the organization as expected from them by the shareholders. Corporate governance promotes corporate fairness, transparency and accountability and it sets up ways on how the various participants' shareholders and other stakeholders cooperate in executing the various directions and performances of corporations (Muriithi, 2011). The corporate governance stakeholders in the banking sector include; the CBK, board of directors, shareholders, management, External auditors and the Capital Markets Authority (CCG,2004). Good governance then holds the management responsible to the shareholders and other

stakeholders. For the firm to achieve its purposes, the board must agree on the company's values and tactics to achieve its purpose. It must report to the shareholders and be responsible for relations with its other stakeholders (Denis D. & J. Mc Connell, 2002).

The performance of most of the organizations depends on the realization of the roles and responsibilities of the boards (Jacob, 2011). The most commonly emphasized roles on the boards are; service dependence and control roles (Daily and strand, 1996). The service role deals with administrative and management issues while the control role entails hiring and firing the executives, directors monitoring managers as fiduciaries of stockholders and determining executive compensation (Njoka, 2010).

The idea of good governance in the banking industry requires quality management in some of the areas such as; management of earnings, asset quality, capital adequacy, liquidity and sensitivity risks (Warner, Jensen and Michael, 1988). Different scholars use different proxies of internal and external corporate governance mechanisms to determine and evaluate their effects on the financial performance of the banks. Of the internal corporate governance variables, board size and composition are frequently used (Fanta *et al.*, 2013). Its mechanisms such as accounting and auditing standards are also designed to monitor managers and improve on the corporate transparency (Frank, *et al.*, 2001). The centre of corporate governance (2004) also suggests that good corporate governance in Kenyan banks will bring a sound financial situation to banking sector; create chance for capital accumulation to reinvest more efficiently into the economy (CCG ,2004).

### **2.3.2 Board Structure.**

Board structure refers to the factors relating to and comprising of the board they include; the number of board members, number of independent candidates and the number of meetings held in a year.

Small boards tend to improve the performance of the firm at all levels compared to the larger boards that are outweighed by cumbersome decision-making and poor communication (Otieno, 2012). Firms with smaller boards of a minimum of five members were better informed about the

earnings of the firm and hence regarded as having better monitoring abilities (Vafeas, 2000) and (Mak and Yuanto, 2003).

The agency theory assumes that smaller boards are better compared to the larger boards since they mitigate the agency cost by effective control over the management while large boards increase the potential interactions and conflicts among the group members. Boards with seven to eight members are better compared to those with a greater number (Yoshikawa and Phan, 2003). As the board size increases, the board's ability to monitor management (Jensen, 1993). Firms with large boards can face challenges of, maintaining, planning, coordinating and decision-making (Wanyama & Olweny, 2013).

Banks tend to have large boards due to their complex organizational structure and presence of more committee such as lending and credit risk committees (Adam & Mehran, 2003, 2005). A large board is comprised of experts from various fields; however an excessively large board will drag down the efficiency of the board and also the effectiveness of corporate governance mechanism (Yermack, 1996).

There are mixed results from various researchers concerning the board size and the financial performance in that. Chan and Li (2008) and Mustafa (2006), found a negative relationship with large boards, while Zahra and peace (1989); Mark and Li (2001) argue that there's a relationship between board size and firm performance while Ghabayen (2012), Bhagat and Black (2002) and Limpaphayom and Connelly (2006) argue that there's no relationship between the board size and firm performance.

Board diligence is one of the factors that can affect the performance of a firm. It comprises of the members' qualifications and the number of meetings held. A more diligent board devotes more time for supervision of the management activities in order to achieve the shareholders' expectations (Vafeas, 1999). Boards that hold regular meetings tend to remain knowledgeable, focused and informed concerning an organizations' performance. (Abbott, Parker and Peter 2004). In relation to the code of corporate governance in Nepal, boards have to hold meetings at least twelve times a year (Poudel and Hovey 2013). Vafeas (1999), found negative relationship between board diligence and a firm's performance while Ponnu and Karthigeyan (2010) did not find any

significant relationship between frequency of board meetings and firm's performance in Malaysian firms.

The banking sectors due to their complexity tend to have larger boards and more committees that require effective monitoring for them to achieve their objectives and goals. The frequency of the meetings and the increased supervision of the top management show a more effective monitoring role that reduces the agency costs and improve on the firms' performance. (Adams & Mehran, 2003). The frequency of board meetings may indicate active monitoring by the board (Conger, Finegold and Lawler, 1998). The findings for this study indicate that board meetings ought not to be frequent but rather emphasis on the quality of the agenda in order to give a positive result on the loan performance of commercial banks in Kenya.

There are mixed reactions on how the directors' average age affects a firms' performance. Senior directors tend to have more experience and knowledge that facilitates effective monitoring hence reducing the agency costs but they may as well lack the incentive and energy to actively monitor managers which may lead to severe agency problems (Grove *et al.* 2011). Outside directors whose age is above 70 tend to be associated with higher compensation rates and weaker corporate governance systems (Core *et al.*, 1999). The National Association of Corporate Directors (NACD) reform acts suggested setting a retirement age and limiting the amount of time served by directors (Berman 2008). Larcker *et al.*, (2007) do not find any relationship between average directors' age and performance.

Board independence is very important since it brings about professionalism by monitoring the managers and mitigating the agency cost by allowing the independent directors on board to have proper monitoring and controlling of the management activities (Poudel and Hovey, 2013). A number of researchers have argued that a higher percentage of independent non-executive directors minimize the agency problems (Choe and Lee, 2003). Successful boards consist of greater percentage of outside directors (Zahra & Pearce, 1989).

Managers of an organization are likely to affect the decisions made by the non-independent directors and this may lead to high managerial entrenchment (Grove *et al.*, 2011). (Klein, 2002) Higher presentation of the outside directors in the board leads to lower conflicts of interest, fewer holdings of stock and accruals by the executive members. Lasfer, (2006) argues that as managerial

ownership increases, managers use their ownership power to select a board that is unlikely to monitor the activities of a firm. Firms that have a high managerial ownership tend to use their own powers to promote a lower proportion of outsiders on the board. This board is unlikely to monitor and even separate the roles of the CEO and that of the chairman hence giving the managers a chance of promoting their own interests over those of the shareholders

Even if the executive directors have a deeper understanding of the firm in terms of the; policy formulation and implementation, knowledge ,expertise and specialized skills, there is need for the independent directors to be included in the board to increase the independence levels, introduce new ideas and raise the objectivity levels of a firm (Choe & Lee, 2003). The banking industry tends to exhibit complexity in terms of their management and information out ray .This makes it easier for higher insider representation and over exploitation of the outside investors which later increases the agency problems (Grove *et al.*, 2011).

Various researchers like Baysinger and Butler (1985), Connel and Servas (1990), Ezzamel and Watson (1993) found a positive relationship between outside directors and a firm's performance. Loder and Martin (1997), Wen, Rwegasira, and Bilder,(2002), and Brick & Chidambaram,(2008) found a negative relationship between outside directors and a firm's performance while Kajola, (2008) did not find any significant relationship.

### **2.3.3 Audit Structure**

Shareholders of any firm need the protection of the auditors since the managers may decide to act for their own interests. The major role of audit committee is to improve the quality of the financial reports of a firm which will result to better performances (Pincus, *et al.*, 1989). It is likely that larger audit committee have better resources than smaller audit committee (De Zoort, *eta al.*, 2002). The decision making literature suggests that the more the number of people involved in an activity, the higher the performance due to less wrongs (Burton, *et al.*, 1977).

Results from different researchers' shows mixed result regarding audit committee size and a firm's performance. Klein (2002) and Coleman-Kyereboah (2007) found a positive relationship between audit committee size and a firm's performance whereas Hardwick, *et al.*, (2003) and Kajola (2008) reported no relation between audit committee's size and performance. This then gives room for more study on this area. Many researchers do concur that the independence levels of the audit

committee is positively related to corporate governance. Independent audit committee from management should be able to prevent management from manipulating the financial results of a firm this is because they do not have any relationship with the management (Beasley, 1996) this is because they do not have any relationship with the management (Abbott *et al.*, 2004).

Erickson, *et al.*, (2005), argues that the independent directors can minimize agency problems like the independent audit committee. Klein, (2002) and Weiss (2005) observed a negative relationship between audit committee independence and a firm's performance while Coleman-Kyereboah, (2007) and Kajola (2008) did not find any significant association between the independence of the audit committee and the performance of a firm.

The frequency of meetings can be used as a measure of diligence, and therefore, audit meeting frequency in this case can be used as a proxy for diligence (Menon and Williams, 1994). Therefore for the audit committee to be effective, the members must be willing to invest a significant amount of energy and time (Kalbers and Fogarty, 1993). Abbott, *et al.*, (2003) argues that the more frequent the audit committee meets the better the financial performance. The quality of the meetings also needs to be looked at since an increase in the number of meetings does not essentially lead to better firm performance (Rebeiz & Salameh 2006). Huang *et al.*, (2008) did not observe any relationship between audit diligence and a firm's performance.

#### **2.3.4 CEO Duality**

CEO duality refers to a situation in which the position of the chairperson and that of the CEO are held by an individual. This view has been called the "Stewardship Theory" (Donaldson and Davis 1991; Braun and Sharma 2007). Combining the positions of chairperson and that of the CEO may result to less performance of a firm due to inadequate oversight and monitoring by the board and this can lead to an increase in the agency costs Coles *et al.*, (2001).

Holding both positions, reduces the agency costs hence leading to better performance of the firm (Alexander, *et al.*, 1993). Contrary, holding both positions can result to poor performance of a firm since the board may not be able to exercise the duty of evacuating a less performing CEO and this will result to an increase in the agency costs in order to reduce the CEOs personal interests at the cost of the shareholders (White and Ingrassia, 1992). Holding the position of the chair and that of

the CEO brings a tendency on an individual of pursuing the personal interests and this may result to the collapsing of the whole firm (Jensen & Meckling 1976).

A company can reduce the conflict of interest between shareholders and management by separating the tasks of decision management and decision control (Boyd, 1995). Empirical findings by Kajola, (2008) indicate a positive and statistically significant relationship between the CEO duality and performance while Yermack, (1996) finds that firms are more valuable when different individuals hold the office of the CEO and that of the chairperson. CEO duality affects the firms performance negatively whereas large and independent boards foster firm value

( Kyereboah-coleman ,2007).

### **2.3.6 Bank performance.**

In spite of the generally accepted concept that effective corporate governance enhances firm performance, other studies have not reported a positive relationship between corporate governance and firm performance (Bathala and Rao, 1995) and others have not found any relationship (Singh and Davidson, 2003; Young, 2003). Several explanations have been given to account for these apparent inconsistencies. A few have argued that the hitch lies in the use of publicly available data which are limited in scope. It has also been outlined that the nature of performance measures (i.e. restrictive use of return on equity (ROE), accounting based measures such as return on assets (ROA), return on capital employed (ROCE) , or restrictive use of market based measures could also contribute to this inconsistency (Gani and Jermias, 2006). Even though the banking institutions have become increasingly complex, efficiencies and earnings are the underlying factors of firm performance (Grove *et al.*, 2011). Hence, traditional accounting performance measures for banks are similar to those applied in other industries with *ROA* being the most widely used. Researchers such as; (Larcker *et al.*,1988), employed the use of *ROA* and found a relationship.

Poudel and Hovey, (2013) also employed the use of the macro-economic and bank specific and control variables i.e. gross domestic product growth rate, loan growth and capital adequacy ratio as bank specific variables and broad money supply to examine the relationship between corporate governance and banks' efficiency. They employed the use of the NPLs as a measure of efficiency and found a positive relationship.

The non-performing loans (NPLs) ratio is mostly used as a measure of loan quality by most of the rating agencies in the banking industry and this is in line to the banks' lending practices. The (NPLs) is calculated as the amount of non-performing loans over total loans. NPLs include loans that have been defaulted by the customers (have not been paid for over 90 days) and reflects the level of losses in the banks' loan portfolio. This variable consists of non-accrual loans (i.e., loans that are still shown in the loan portfolio but for which no interest income is being accrued; (interest income on these loans is recorded on a cash basis), restructured loans, foreclosed properties, and repossessions (Grove *et al.*, 2011). Several studies have employed this variable as a measure of bank performance (Beck *et al.*, 2005; Berger and De Young, 1997; Berger *et al.*, 1995).

The study has added to the existing literature in that it has employed the use of the market based performance measure which is the loan quality. The findings indicate that there is a positive relationship between the corporate governance variables (BS, AS and CEO Duality) and the loan performance of the Kenyan commercial banks.

## **2.4 Literature overview**

Choi and Hasan (2005) studied the effect of ownership and corporate governance on Korean bank's performance during 1998 – 2002 by using a simple ordinary least squared model reporting that the existence of one foreign director on the board improves bank performance significantly, but multiple foreign directors on the board do not improve bank's performance. Kyereboah-Coleman and Biekpe's (2006) study examined the role of boards and CEOs in the performance of the Ghanaian banking sector examining 18 banks both listed and not – listed for the period 1997 – 2004 by adopting panel data to support their model. They found out that more independent the board is the less the profits.

Roe (2004) looked at the institutions of corporate governance in the West and argued that institutions face two problems: horizontal governance problems (between close, controlling shareholder and distant shareholder) and vertical governance problems (between distant shareholders and managers). Akpan and Riman 2012 examined corporate governance and Bank performance in Nigeria between 2005 and 2008 and found out that a unit change in the size of the board of directors of the bank and the size of shareholders (Corporate Governance) lead to better bank performance between 2 percent and 18 percent. Jensen and Meckling (1976) suggests that



ownership structure ,board structure, and compensation structure are evaluated by a range of variables, such as risk, cash flow, firm size, real and financial assets, and regulations these variables as well influence a firm's conduct and performance.

Barako and Tower (2007) studied the relationship between ownership structure and bank performance in Kenya. They included all financial institutions operating in Kenya and used a multivariate regression with the following variables; ROA, ownership and bank size .They found a positive relationship between ownership structure and bank performance. In particular, board ownership is significantly and negatively related to performance and foreign ownership has a significant positive effect on bank's performance.

Ongore and Kusa 2013, conducted a study on the determinants of financial performance of commercial banks in Kenya and used linear multiple regression model and Generalized Least Square on panel data to estimate the parameters. Their findings showed that bank specific factors significantly affect the performance of commercial banks in Kenya, except for liquidity variable. But the overall effect of macroeconomic variables was inconclusive at 5% significance level which indicated that the microeconomic factors have insignificant contribution on the financial performance of commercial banks. Otieno ,2012 examined the Corporate Governance factors and Financial Performance of commercial banks in Kenya and used Statistical Package for Social Scientists (SPSS) and Spearman Correlation Coefficient and Multiple Regression Analysis to determine the magnitude of the relationship and prediction of financial performance respectively. He used a sample ratio of 0.3 to obtain a sample representation of the entire population that comprises of 44 commercial banks. He found out that corporate governance factors (corporate governance practices and corporate governance policies) accounts for 22.4 % of the financial performance of commercial banks.

Mangunyi 2011, examined ownership structure and corporate governance and it's effects on performance of firms in Kenya with reference to banks. The study revealed that there was no significant difference between banks ownership structure and corporate governance practices and the type of ownership and financial performance. The results further revealed that there was significant difference between corporate governance and financial performance of banks. However, foreign-owned banks had slightly better performance than domestically-owned banks. Kibugi 2008, conducted a study on the effects of corporate governance on the financial

performance of commercial banks in Kenya using all the 48 commercial banks as the sample size and also incorporating the use of statistical package for social scientists to process the data and found out that corporate governance practices (risk management, regulatory framework and bank transparency) affects the financial performance of the banks.

From the reviewed literature above, it can be noted that a number of studies on corporate governance and its effects on bank performance focused mainly on organizational ownership, organizational policies, risk-management and organizational culture (Kibugi 2008; Mangunyi 2011 and Otieno, 2012).None of the reviewed studies captured on the effects of corporate governance on loan performance of commercial banks in Kenya.

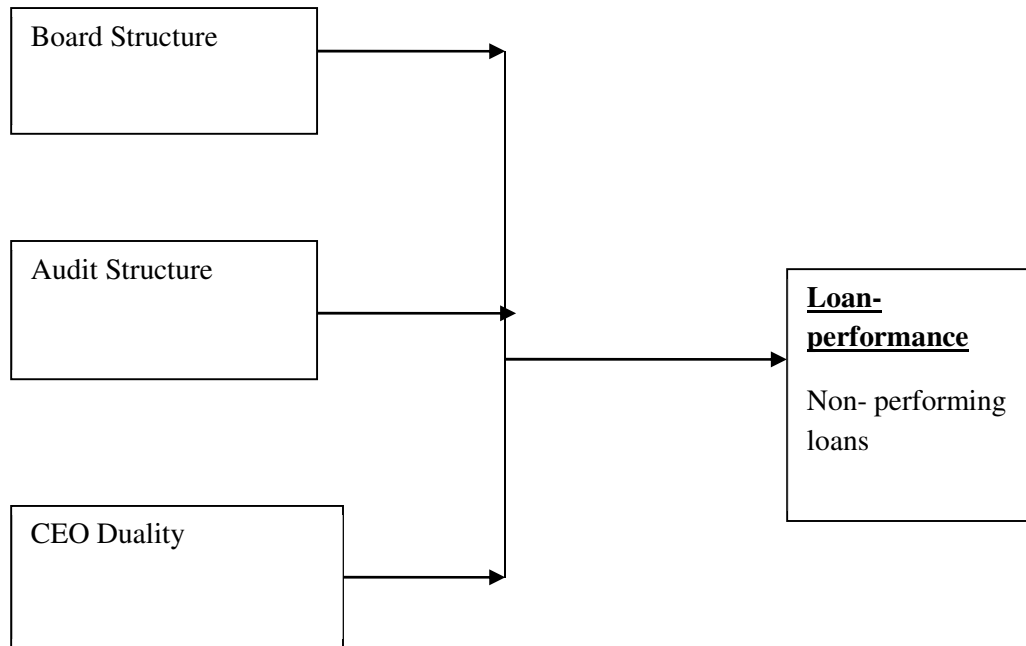
The objectives of this paper is therefore to examine the impact of corporate governance mechanisms i.e. board structure, audit structure and CEO duality and their effects in the loan performance of banking industry in Kenya. The study then contributes to the existing literature from different perspectives. Moreover, the study covered 43 commercial banks for the period, 2010-2014, when most of the regulatory decisions were taken by the central bank of Kenya for the corporate governance.

## **2.5 Conceptual Framework.**

From the reviewed literature, the relation between the dependent and independent variables is conceptualized to be as shown in figure 2.1.

**Corporate governance variables**

**Performance variable**



**Figure.2.1conceptual framework**

Source, Author, 2016.

From figure 2.1, the independent variables include; board structure, audit structures and the CEO duality while the dependent variable is the loan performance which is measured by the NPLs .

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

The chapter describes the procedure that is to be followed while conducting the study. It covers the research design, model specification, definition and measurement of variables, research instrument, the study area & the study population, sampling and the type of data to be collected. In terms of methodology this study is guided by Poudel and Hovey, (2013) works.

#### **3.2 Research design.**

In order to look at corporate governance and its effects on the loan performance in the Kenyan commercial banks, the study adopted a descriptive research design. The design entailed collecting data in order to answer questions concerning the current status of the subject. The design enabled respondents to give their relevant information on the issue of interest to the study hence getting accurate results. The design incorporated both the quantitative and qualitative data hence making it to be preferred for the study compared to the other methods.

#### **3.3 Target population**

For this study, the population consisted of all 43 commercial banks as per the central Bank of Kenya and the Kenya Bankers Association. A census was deemed appropriate since the target population was small hence manageable.

#### **3.4 Data collection instruments.**

Data for the study was collected from both the primary and secondary sources. The primary data was collected through use of questionnaires while the secondary data was from the financial reports and statements of the various commercial banks that were under study and also from the CBK. The questionnaires contained both closed and open-ended questions.

### 3.5 Data collection procedure

Using introductory letters from the School of Post Graduate studies of Machakos University for presentation at the National Commission of Education Science and Technology (under the MOE), the researcher had to seek and obtain permission to collect data from the 43 commercial banks. Pilot-testing method was used in testing the validity and reliability of the primary and secondary instruments.

### 3.6 Data processing and analysis.

Stata version 13 was used to process data in order to determine the relationship between variables. Both descriptive and inferential statistics were used for analysis. Descriptive statistics included the use of mean, standard deviation, frequencies and percentages while inferential statistics included the use of the karlpearsons correlation coefficient and the multi- regression to determine the relationship between the corporate governance variables and the loan performance indicator.

### 3.7 Theoretical Model

There was a statistically indicative effect for bank corporate governance (i.e. BS, AS, and CD) and the INPLs as the financial indicator.

$$\text{INPLs} = \beta_0 + \beta_1\text{BS} + \beta_2\text{AS} + \beta_4\text{CD} + e$$

Where, **BS (Board Structure) = BSz + BI + BD**

$$\text{AS (Audit Structure) = ACSz + ACI + ACD}$$

e= Standard Error

### 3.9 Definition and measurement of variables

The independent variable which is corporate governance was proxied by board structure, audit structure and the CEO duality. Board and audit structure were measured in terms of size, independence and diligence levels. Loan performance as the dependent variable was also measured using the linearized non- performing loans ( INPLs) This is because money was found to be a continuous variable hence poor to control and therefore the researcher introduced logs in order to reduce the errors. . Table 3.1 shows the definition and measurement of variables.


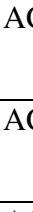
$$INPLs = \beta_0 + \beta_1 BS + \beta_2 AS + \beta_4 CD + e$$

Where, **BS (Board Structure) = BSz + BI + BD**

**AS (Audit Structure) = ACSz + ACI + ACD**

e= Standard Error

**Table 3.1 Definition and measurement of variables**

Financial performance (INPLs)	Non-Performing Loans(linearized)	Ratio of non-performing loan to total loan at the end of each year	
	BSz	Board Size	The number of directors on the board at the end of each year
	BI	Board independence	The ratio of independent directors to board size at the end of each Year
	BD	Board Diligence	The number of board meetings held during the financial year
	ACSz	Audit Committee size	The number of members in audit committee at the end of each year
	ACI	Audit Committee independence	The ratio of independent directors to audit committee's size at the end of each year
	ACD	Audit Committee diligence	The number of audit committee meetings held during the financial year
CD	CEO Duality	Whether the CEO and board chair are one and the same person	

(Source, Author 2016)

## CHAPTER FOUR

### PRESENTATION, INTERPRETATION AND DISCUSSION OF THE FINDINGS

## 4.1 Introduction

This chapter describes the analysis of data and gives the research findings. The findings are presented in form of tables.

## 4.2 Response Rate

Out of the 43 commercial banks that were surveyed, only 30 responded and this represents 69.8% as shown in table 4.1.

**Table 4.1 Number of banks surveyed**

<b>Banks</b>	<b>Frequency</b>	<b>Percentage</b>
Those that responded	<b>30</b>	<b>69.8%</b>
Those that didn't respond	<b>13</b>	<b>30.2%</b>
<b>Total</b>	<b>43</b>	<b>100%</b>

Source: Survey Data 2016

## 4.3 Characteristics of the commercial banks studied.

The Banks age, Directors age and education, number of directors and the appointment of the directors emerged as the main characteristics that the study had to include in the questionnaire. The characteristics give insight information concerning corporate governance in the banking institution.

### 4.3.1 Banks age

The study sought to find out for how long the banks studied had been in existence. It is of importance to the study since it tells for how long corporate governance has been administered and for how many banks. This is as shown in table 4.2. 33% which is the highest percentage contains those banks that have existed for 1-20 years a total of 10 banks fall in this category. 30% represents the 9 banks that have existed from 21-40 years followed by 27% that has 8 banks whose age bracket is 41-60 years and lastly 10% that contains 3 banks that have stayed for more than 60 years.

**Table 4.2 Banks age**

<b>Age</b>	<b>Number of Banks</b>	<b>Percentage</b>
<b>1-20 years</b>	<b>10</b>	<b>33%</b>
<b>21-40 years</b>	<b>9</b>	<b>30%</b>
<b>41-60 years</b>	<b>8</b>	<b>27%</b>
<b>Above 60 years</b>	<b>3</b>	<b>10%</b>
<b>TOTAL</b>	<b>30</b>	<b>100%</b>

Source: Survey Data 2016

#### **4.3.2 Director's age and the Educational level**

Table 4.3 that contains the regression summary for the education and age levels indicates that; for the five years, there was a falling trend in terms of the INPLs. In reference to appendix 6 the masters' holders were able to reduce the INPLs by 2.77 in 2010 while in 2014 they reduced it by 0.42 same case to the PhD holders who reduced the INPLs by 2.76 in 2010 and this farther reduced to 0.43 in 2014. In general, the higher the educational levels the lower the INPLs hence better loan performance. The second category of the age of 36-50 increased the levels of the INPLs ratio for the five years with an average of 7.16 compared to the third category of the age 51-70 that increased the INPLs ratio by an average of 6.16. This indicates that the age bracket of 51-70 is preferred over the second category of 36-50 because it reduces the INPLs by 1.0 hence leading to better loan performance.

All the banks have most of their director's age ranging from 51-70 years and their educational level are up to the masters level indicating that they have enough energy, experience and knowledge concerning matters related to the banking industry. This then becomes relevant to the study in that, directors have the authority and responsibility of ensuring that the institutions finds competent management team with the right skills and competency levels and by doing that then it means that they mitigate the agency problems between the shareholders and the management



team. Secondly, the directors formulate and pass crucial policies, strategies and decisions meaning that they need to possess the expertise and enough experience on the current financial products and this implies that they need to sit for long hours in their meetings in order to archive the objectives and goals of the institution.

**Table 4.3 Regression table for the director's educational levels and age**

(1)		(2)	(3)	(4)	(5)
	INPLS2010	INPLS2011	INPLS2012	INPLS2013	INPLS2014
1.education (coefficient)	0	0	0	0	0
t-statistics	(.)	(.)	(.)	(.)	(.)
2.education) (coefficient)	-2.777	-1.943	-0.272	-1.227	0.422
t-statistics	(-1.194)	(-1.646)	(-1.306)	(-0.644)	(0.833)
3.education (coefficient)	-2.766	-1.578	-0.362	-0.162	-0.438
t-statistics	(-1.176)	(-2.032)	(-1.146)	(-0.846)	(-1.256)
1.board age (coefficient)	0	0	0	0	0
t-statistics	(.)	(.)	(.)	(.)	(.)
2.board age (coefficient)	5.398	7.485*	12.58**	3.749*	6.743***
t-statistics	(2.729)	(2.916)	(2.668)	(1.492)	(1.146)
3.board age (coefficient)	3.799	5.608	10.91***	4.446**	6.073***
t-statistics	(1.991)	(2.483)	(1.803)	(1.006)	(0.993)
4.board age (coefficient)	0	0	0	0	0
t-statistics	(.)	(.)	(.)	(.)	(.)
_cons	-1.923	-7.091	-15.65*	8.227*	9.864***
	(-5.128)	(-5.366)	(-4.904)	(2.465)	(1.656)
* p<0.001					

Source: Survey Data 2016

#### 4.3.3 Number of Directors

The number of board members ranges from 5 board members to 21 members for the studied banks. Table 4.4 shows the number of banks that contains a given range of directors and the percentages.

**Table 4.4 Number of directors**

<b>Number of directors</b>	<b>Number of Banks</b>	<b>Percentage</b>
<b>1-7</b>	<b>5</b>	<b>17%</b>
<b>8-12</b>	<b>18</b>	<b>60%</b>
<b>13-20</b>	<b>6</b>	<b>20%</b>
<b>Above 20</b>	<b>1</b>	<b>3%</b>
<b>TOTAL</b>	<b>30</b>	<b>100%</b>

Majority of the banks have their boards ranging from 8-12 members and this is represented by 60%. 20% of the banks have their boards ranging from 13-20 followed by 7% that represents the boards with 1-7 members and lastly for those banks that have boards above 20 members. From table 4.6, a board of 10 members is deemed fit but from the regression summary table 4.7 this was not found to be significant.

#### **4.3.4 Appointment and effectiveness of the Directors**

A formal and transparent procedure in the appointment of the board members was employed and observed by the banks that responded to the questionnaires. Table 4.4 shows some of the options taken by the banks when selecting their board members.

**Table 4.5 Board members appointment**

<b>Type of election</b>	<b>Number</b>	<b>Percentage</b>
By vote of majority shareholders	<b>8</b>	<b>27%</b>
By vote of all shareholders	<b>19</b>	<b>63%</b>
By old board when a new one is coming.	<b>2</b>	<b>7%</b>
Other processes	<b>1</b>	<b>3%</b>
<b>TOTAL</b>	<b>30</b>	<b>100%</b>

Source: Survey Data 2016

It is noted that most of the board members are appointed by the vote of all shareholders which represents 63%, followed by the vote of majority shareholders 27% by the old board when a new one is coming into office (7%) and then lastly other processes (3%) this represents the appointment by the government through treasury. The board then can be able to represent the interests of all shareholders and stakeholders hence reducing any conflicts that may arise. Most of the boards are reported to be effective in terms of leadership, integrity and decision making. Effective boards offer better services to the shareholders and stakeholders hence promoting an efficient financial position in a company through proper accountability, transparency and responsibility.

**4.4 Empirical findings.**

The major objective of this study is to find out the effect of corporate governance on the loan performance of commercial banks in Kenya. The independent variables includes the BS that comprised of the board size, board independence and board diligence, AS that comprised of the audit size, audit independence and audit diligence and the chief executive officer duality. The dependent variable which is the loan performance is measured by the INPLs.

**4.4.1 Board structure and loan performance**

The first objective of the study sought to evaluate the effect of board structure on loan performance of commercial banks. Board structure is a combination of the board size, board independence and board diligence. The result in table 4.5 shows that the mean value of the board size is 10.4 with 0.43 independence levels and 5.2 times diligence levels. This then indicates that the Kenyan banks have a board size of 10 members and the members meet at least 5 times a year while 43% of the board is represented by the independent directors.

**Table 4.6 Descriptive Statistics of Dependent and Independent Variables**

**Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
BSz	30	6	20	10.40	3.470
BD	30	1	9	5.17	2.805
BI	30	.0910	.8810	.428770	.2637570
ACI	30	.0340	.9320	.386033	.2585042
ACD	30	2	9	5.17	1.967
CD	30	0	1	.50	.509
NPL	30	.0100	.9010	.419667	.2618508
ACSz	30	3	13	6.97	2.059
Valid (listwise)	N 30				

Source: Survey Data 2016

Table 5.0 shows that the board size has a negative correlation with the non-performing loans while the board independence and board diligence had a positive correlation. Board diligence and board independence showed the highest correlation of 72% hence indicating that there was no multicollinearity in the study. Multicollinearity problems exist when the correlation between the

independent variables exceeds 90%. A significant positive correlation is also found between the board size and the board independence indicating that the Kenya Commercial banks have more than one independent director and therefore an increase in board size maximizes the board independence.

Table 4.7 clearly indicates that for the five years, board structure has a positive relationship of 19.5% and it is not significant to the NPLs. BSz was the only factor that at least showed a significantly negative relationship of -2.074 in the year 2013 which at the end was not significant.

**Table 4.7 Regression summary for Board structure**

	INPLS2010	INPLS2011	INPLS2012	INPLS2013	INPLS2014	AVERAGE
BS	0.9328	0.1793	0.1654	-0.2494	-0.0529	0.1950
	(0.2834)	(0.3582)	(0.6001)	(-1.0267)	(-0.3986)	(0.1212)
BSz	0.9796	0.5033	0.0553	-0.0834	-0.00798	
	(0.9032)	(0.3904)	(0.6803)	(-2.0741)	(-0.1712)	
BD	-0.5942	-0.9023	-0.4810	-0.6647	-0.1651	
	(-0.8846)	(-0.8632)	(-0.0164)	(-1.6152)	(-0.2923)	
BI	2.413*	0.937	0.922	0.00150	-0.0143	
	(0.8284)	(1.5473)	(1.1310)	(0.6004)	(-0.7332)	
_cons	-1.923	-7.091	-15.65*	8.227*	9.864***	
	(-5.128)	(-5.366)	(-4.904)	(2.465)	(1.656)	
* p<0.001						

Source: Survey Data 2016

#### 4.4.2 Audit Structure and loan performance

The second objective ought to determine the relationship between the audit structure and loan performance of commercial banks in Kenya. Board structure is a combination of the audit committee size, audit committee diligence and the audit committee independence. The findings in table 4.6 show that the mean value of the audit size was 7 with 0.39 independence levels and 5.2 times diligence levels. This then indicates that an audit committee of 7 members with the members

meeting at least 5 times a year does better for the commercial banks of Kenya. It also indicates that 39% of the committee size is constituted of the independent directors.

Table 5.0 indicates that there is no any significant relationship between the audit committee size and the independence however; the results indicate that there is a positive correlation since an increase in the audit committee size improved the audit committee diligence. Table 4.8 shows that audit structure in general has a significantly positive relationship of -1.825 with the INPLs meaning that an increase in the level of the AS reduces the INPLs hence leading to better loan performance of the Kenyan commercial banks. Audit committee size and audit diligence showed a significantly negative relationship for the consecutive three years that is 2010 to 2012 after which the significance levels reduced all through to 2014. Audit independence showed a positive relationship with the NPLs although it was not significant.

**Table 4.8 Regression Summary for Audit Structure**

	INPLS2010	INPLS2011	INPLS2012	INPLS2013	INPLS2014	AVERAGE
AS	-1.6087	-2.12575	-4.9855	2.6515	2.8471	-0.64429
	(-3.1985)	(-2.2342)	(-3.8203)	(0.043)	(0.0815)	(-1.8257)
3.ACz	-2.118	-0.855	-2.638	-1.209	-1.406	
	(-1.864)	(-2.610)	(-2.042)	(-1.064)	(-0.953)	
2.AI	1.456	1.297	0.859	0.915	2.476**	
	(0.421)	(1.118)	(0.473)	(0.125)	(0.493)	
3.AD	-3.850*	-1.854	-4.454***	2.673**	-2.071*	
	(-1.823)	(-2.159)	(-1.730)	(0.601)	(-0.830)	
_cons	-1.923	-7.091	-15.65*	8.227*	9.864***	
	(-5.128)	(-5.366)	(-4.904)	(2.465)	(1.656)	
* p<0.001						

Source: Survey Data 2016

#### 4.4.3 CEO Duality and loan performance

The third objective sought to assess on how the CEO duality affects the loan performance of the commercial banks. Findings from table 4.9 shows that the CEO duality has a significantly positive relationship of 0.8192 with the INPLs indicating that an increase in the holding of the same office by an individual increases the NPLs levels hence reducing the levels of loan performance of the Kenyan commercial banks. the separation of powers of the chairperson and that of the chief executive officer have a positive impact on the loan performance of the commercial banks.

**Table 4.8 Regression summary for the CEO Duality**

	INPLS2010	INPLS2011	INPLS2012	INPLS2013	INPLS2014	AVERAGE
CD	2.016	0.937	0.562	0.346	0.253	0.8192
	(2.480)	(1.547)	(2.234)	(1.742)	(1.651)	(1.9308)

Source: Survey Data 2016

#### **4.5 Correlation of the corporate governance variables with the loan performance.**

A correlation matrix table had been generated in order to answer the study questions. The board and audit structure variables had to be examined separately to find out their relationship status first with the loan performance before a comprehensive answer would be given concerning the board and audit structure variables. Table 5.0 then shows the correlation matrix for all the elements in the theoretical model 3.7.

**Table 5.0 Correlation matrix of Dependent and Independent Variables**

#### **Correlations**

		BSz	BI	BD	ACSz	ACI	ACD	NPL	NS	CD
BSz	Pearson Correlation	1								
BI	Pearson Correlation	.105	1							
BD	Pearson Correlation	.319	.717**	1						
ACSz	Pearson Correlation	-.148	-.285	-.321	1					
ACI	Pearson Correlation	.006	.546*	.342	.020	1				
ACD	Pearson Correlation	.212	.659**	.545**	.314	.239	1			
NPL	Pearson Correlation	-.032	.382*	.335	.022	.037	.233	1		
CD	Pearson Correlation	-.137	.106	-.360	.016	-.127	.086	.310	-.185	1

Source: Survey Data 2016

The results show that board size was negatively correlated while the board diligence, board independence, audit committee size, audit committee diligence ,audit committee independence and CEO duality had a positive correlation with the loan performance .There was also a strong correlation between board diligence and board independence at 0.717. However all this is insignificant and the results had farther to be tested by the use of regression analysis.

#### 4.6.1 Regression model summary



Table 5.1 shows the average R square which is the proportion of variation in the dependent variable as 86%. This indicates that BS, AS and CD accounts for 86 % of the financial performance of the Kenyan commercial banks. 2012 presented the highest percentage of 92% while 2011 presented the least (69%).The adjusted R square is 58% showing a relationship between the observed and predicted values of the dependent variable. The average root mean of standard errors was 0.969 while the residual for the predictors was at 42% and this showed that the overall result was robust and statistically significant. The AS and the CD emerged out to be significant with a t-statistic of -1.83 and 1.9 respectively while BS was not found to be significant since its t-value was less than 1.8.

**Table 5.1 – Regression analysis (Model summary)**

	INPLS2010	INPLS2011	INPLS2012	INPLS2013	INPLS2014	AVERAGE
N	30	30	30	30	30	30
R-Square	0.912	0.693	0.923	0.906	0.868	0.860
Adj. R-square	0.637	0.532	0.681	0.613	0.454	0.583
Root mean of Std. Errors	1.049	1.664	0.819	0.568	0.749	0.969
R						.415 <sup>a</sup>
* p<0.001						

a. Predictors: (Constant), BS, AS, CD

Source: Survey Data 2016

## CHAPTER FIVE

### CONCLUSION AND RECOMMENDATIONS

#### 5.1 Introduction

The main objective of this paper is to examine the impact of corporate governance variables on the loan performance of the commercial banks in Kenya. The chapter then presents a summary of the data analyzed, the conclusions, recommendations and suggestions in relation to the study.

#### 5.2 Summary ad findings

The following findings were acquired for the study. The response rate was at 69.8% and out of those that responded, majority of the banks are those that have existed from 1-20 years and they accounted for 33% followed by those that have existed from 41-60 years whose percentage was 27%. This then tells that most of the banks have been in the system of implementing the elements of corporate governance. Out of the banks that responded, 63 % of the board members were appointed by the shareholders and 60% of the banks had their boards ranging from 8-12 board members.

In terms of the bank's age, most of the banks were those that have been in operation for less than 20 years and this was represented by 33% of those banks that responded. 9 banks were also found to have been in existence from 21-40 years followed by 8 banks whose age bracket is 41-60 years and lastly 3 banks that have stayed for more than 60 years.

Higher educational levels and the age of the directors were found to be of importance to this study in that those directors who were in the age bracket of 51-70 reduced the INPLs by 1% over those that were in the age bracket of 36-50 years and the result indicated that most of them were masters holders. . This then indicated that this directors have enough energy, experience and knowledge concerning matters related to the banking industry and have the authority and responsibility of ensuring that the institutions finds competent management team with the right skills and competency levels.

Board structure as a combination of the board size, board independence and board diligence showed that majority of the banks have their boards being 10 with the members meeting 5 times a year and their independence levels being at 43%. For the five years, board structure has a positive relationship of 19.5% indicating that as the BS increases, the INPLs also increases hence leading to a decrease in the loan performance of the Kenyan commercial however all this was found not to be significant in the study since BS has a significance level of 0.1212.

AS in general has a significantly positive relationship of -1.825 with the INPLs meaning that an increase in the level of the AS reduces the INPLs hence leading to better loan performance of the Kenyan commercial banks. Audit committee size and audit diligence showed a significantly negative relationship for the consecutive three years that is 2010 to 2012 after which the significance levels reduced all through to 2014. Audit independence showed a positive relationship with the NPLs although it was not significant.

CEO duality has a significantly positive relationship of 0.8192 with the INPLs indicating that an increase in the holding of the same office by an individual increases the INPLs levels hence reducing the levels of loan performance of the Kenyan commercial banks and therefore a need to separate the powers of the chairperson and that of the chief executive officer for the banks to perform better.

The R square which is the proportion of variation in the dependent variable is at 86%. This means that BS, AS and CD accounts for 86 % of the financial performance of the Kenyan commercial banks. The AS and the CD emerged out to be significant with a t-statistic of -1.83 and 1.9 respectively while BS was not found to be significant since its t-value was less than 1.8. The adjusted R square is 58% showing a relationship between the observed and predicted values of the dependent variable. The average root mean of standard errors was 0.969 while the residual for the predictors was at 42% and this showed that the overall result was statistically significant. A test of multicollinearity was conducted and board diligence and board independence showed the highest correlation of 72% hence indicating that there was no multicollinearity in the study.

### **5.3 Conclusion**

The study covered 30 commercial banks out of 43 commercial banks. The study covered the recent period, which is 2010-2014, when some of the commercial banks had been placed under receivership. The objective of this study was to examine the effects of corporate governance on the performance of commercial banks in Kenya by using INPLs as the loan performance measure. The study indeed contributes to the existing literature in different perspectives.

The findings of this study have important implication for the Kenyan banks since it is found that BS has a positive relationship with the loan performance in that; bigger boards, lower frequency of the meetings and low insider representation by the independent directors reduces the INPLs hence resulting to better loan performance levels however all this is not significant in this study. AS presents a significantly negative relationship to the loan performance meaning that as it increases, it reduces the INPLs by 0.64 hence resulting to better loan performance. This is a clear indication that the audit committee meetings are higher but more efforts needs to be looked at the quality of those meetings since the margin of 0.64 for five years seems to be little. The audit committees also need to be checked upon on whether they are constituted of some individuals with no expertise in the audit field which may be giving the margin. Independent auditors also ought to prevent the management from manipulating the financial results since they do not have any economic benefit from the management. CEO duality also needs to be emphasized on in that effective separation of the office of the chair and that of the chief executive officer leads to better loan performance for the banks. The commercial banks in Kenya therefore need to observe the governance principles and other guidelines from the CBK in order to boost their loan performance positions.

### **5.4 Limitations**

The limitation of this study is that it relies mostly on the financial accounting reports which are publicly available. The publicly available data suffer from the following errors: are subject to manipulation and may systematically undervalue the assets and they produce alterations due to the nature of the depreciation methods employed. The study considers also data of only five years. The result may differ if multiple and different years are considered for analysis. Certain degree of

subjectivity can also be found since the pretest and post test were conducted by the author meaning that it would have been better if it were subjected to test by two or more researchers.

### **5.5 Recommendation**

The area of corporate governance is an essential area in most sectors both in our country and worldwide and therefore the area requires urgent contribution. There are still many more corporate governance variables and financial performance measures that have not been looked onto by this study. Therefore, regarding future line of research, effort should be put at increasing the year size, corporate governance variables like board expertise, policy formulation and implementation and the board tenure not forgetting on the use of other financial performance measures like ROE and ROA

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## **APPENDIX 1**

### **INTRODUCTION LETTER**

Dear Respondent,

#### **RE: RESEARCH PROPOSAL**

I am a postgraduate student of Machakos University pursuing a Master of business administration in Finance. I am currently collecting data on *effects of corporate governance on the financial performance of commercial banks in Kenya*. The success of this study will greatly depend on your willingness and co-operation to provide the information required .I kindly request you to respond to the questionnaire attached here with as honestly as possible and to the best of your knowledge. The attached questionnaire is specifically designed for the purpose of this study only; and all responses will be treated in absolute confidence and secrecy.

Thank you

Yours Faithfully,

Jane Moragwa Magembe.

D53/1046/2014

## **APPENDIX 2**

### **QUESTIONNAIRE**

This questionnaire will assist in gathering information about the practices of corporate governance in commercial banks in Kenya. All the information gathered will be treated with highest confidentiality and it will be appreciated.

Please tick (~) where applicable.

Date: .....

Name of Bank: .....

**A: Introduction**

1. For how long has this bank been in operation in Kenya? '.....years]

**B: Board Structure**

2. What is the total number of the Board of Directors? .....

3. How is the board appointed?

- (i) By the vote of majority shareholders.
- (ii) By the vote of all shareholders.
- (iii) By the old board when a new one is coming into office.
- (iv) Other processes.
  - (i) .....
  - (ii) .....
  - (iii) .....

4. How effective do you consider the Board to be, in exercising the following so as to achieve the Banks objectives ? Using the following terms

[A] Very effective [B] Not very effective [C] Effective [D] Below average

A B C D

- (i) Leadership ( ) ( ) ( ) ( )
- (ii) Integrity ( ) ( ) ( ) ( )
- (iii) Decision making ( ) ( ) ( ) ( )

5. How frequently does the Board meet?

- (i) Semi-annually ( )
- (ii) Annually ( )
- (iii) Others ( )

6. Does the bank have some independent directors?

- (i) Yes ( )
- (ii) No ( )

7. If yes, how many.....

8. Which is the highest level of education for most of the board members?

Degree ( ) masters ( ) PhD ( )

9. What is the average age of the board members?

20-35 ( ) 36-50( ) 51-70 ( ) Above 70 ( )

**B: Audit Structure**

10. Indicate your level of agreement with the following statements by ticking at the appropriate box.

Use the ratings criteria below.

*1. Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), Strongly Disagree (SD)*

11. The audit committee has regular meetings

12. If so how many times a year (kindly indicate the number).....

13. What is the total number of the members in the audit committee? .....

14. Does the bank have some independent auditors?



(i) Yes ( )

(ii) No ( )

15. If yes, how many.....

16. The audit committees are actively functioning in the bank;

17. How are most of the auditors appointed?

(i) [1] By the vote of majority shareholders.

(ii) [2] By the vote of all shareholders.

(iii) [3] By the board of directors.

(iv) [4] Other processes.....

**C. CEO Duality**

18. Is the chief Executive Officer holding or acting as the chairperson of the board?

(i) Yes ( )

(ii) No ( )

**D. Shareholders and stakeholders**

19. What is the approximate total number of shareholders? (.....)

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

.....  
.....

**E: Bank performance**

21. Could you please provide the figures for the following indicated financial years?

	2010	2011	2012	2013	2014
Total assets`					
Net profit before taxes					

22.	Net profit after taxes					
	Return on share holders fund					
	Total loans					
	Yields on advance					
	Nonperforming assets(un serviced loans)					

Briefly comment on the status of the banks on the following:

a).Lendingbehavior.....  
 .....

b).Capital adequacy  
 .....  
 .....

c).Liabilities.....  
 .....

d).Credit distribution  
 .....

e).Distribution of bank profitability  
 .....

**APPENDIX 3**

**LIST OF COMMERCIAL BANKS IN KENYA**

- 1.ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India

5. Barclays Bank
6. CFC Stanbic Bank
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust bank
15. Eco bank
16. Equatorial Commercial Bank
17. Equity Bank
18. Family Bank
19. Fidelity Commercial Bank Limited
20. Fina Bank
21. First Community Bank
22. Giro Commercial Bank
23. Guardian Bank
24. Gulf African Bank
25. Habib Bank
26. Habib Bank AG Zurich
27. I&M Bank
28. Imperial Bank Kenya
29. Jamii Bora Bank
30. Kenya Commercial Bank
31. K-Rep Bank

32. Middle East Bank Kenya
33. National Bank of Kenya
34. NIC Bank
35. Oriental Commercial Bank
36. Paramount Universal Bank
37. Prime Bank (Kenya)
38. Standard Chartered Kenya
39. Trans National Bank Kenya
40. United Bank for Africa
41. Victoria Commercial Bank
42. HDFC Bank Limited
43. FirstRand Bank

Source: Central Bank of Kenya

#### **APPENDIX 4**

#### **LIST OF LIQUIDATED BANKS IN KENYA FROM 1984-2016**

<b>YEAR</b>	<b>NAME OF THE INSTITUTION</b>	<b>YEAR</b>	<b>NAME OF THE INSTITUTION</b>
<b>1984</b>	Rural credit finance company limited	<b>2000</b>	Reliance Bank limited

<b>1986</b>	Continental Bank of Kenya limited	<b>2000</b>	Fortune finance limited
<b>1986</b>	Continental Credit Finance limited	<b>2001</b>	Trust Bank limited
<b>1993</b>	Post Bank Credit limited	<b>2003</b>	Euro Bank
<b>1993</b>	Trade Bank limited	<b>2005</b>	Daima Bank limited
<b>1993</b>	Delphis Bank limited	<b>2006</b>	Charter house Bank
<b>1993</b>	Exchange Bank limited	<b>2007</b>	Allied Credit
<b>1993</b>	Middle Africa Finance limited	<b>2007</b>	International Finance limited
<b>1993</b>	Pan Africa Credit & Finance limited	<b>2008</b>	Trade Finance limited
<b>1994</b>	Thabiti Finance limited	<b>2008</b>	Dinners finance limited
<b>1996</b>	Meridian Biao Bank	<b>2010</b>	Nairobi finance company limited
<b>1996</b>	Heritage Bank limited	<b>2012</b>	Inter Africa credit finance limited
<b>1996</b>	Kenya Finance Bank limited	<b>2012</b>	Central Finance limited
<b>1997</b>	Ari Bank corporation limited	<b>2015</b>	Dubai Bank limited
<b>2000</b>	Prudential Bank limited	<b>2015</b>	Imperial Bank limited (under statutory management).
		<b>2016</b>	Chase bank (under statutory management)

(Source, Central Bank of Kenya 2015)