

# INFLUENCE OF THE CAPITAL MARKETS AUTHORITY'S CORPORATE GOVERNANCE GUIDELINES ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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## ABSTRACT

*Good corporate governance is indispensable for the survival and performance of corporate entities. The purpose of the Capital Markets Authority's (CMA) Guidelines on good corporate governance was to improve governance practices in the corporate sector, as well as attract and retain investors for sustained economic growth. A rampant trend of commercial banks placed under receivership between 1990 and 2005 inspired this study. As at the time of the study, the Guidelines had been operational for about eight years. Although statistics at that time suggested that the banking sector had improved by reducing the proportion of non-performing loans, there was no documentation linking the Guidelines to this achievement. I sourced primary data from 16 commercial banks, seven of which traded at the Nairobi Stock Exchange (NSE). I applied one-way Analysis of Variance (ANOVA), Pearson's Correlation Coefficient and multiple regression models to analyze the data. The results show that listed and unlisted commercial banks were significantly different in terms of board size, proportion of executive and non-executive directors, gender composition, cost of board maintenance, composition of audit committees, frequency of financial disclosures and more importantly, financial performance. The study emphasizes the need for a legal framework to enforce alignment with CMA Guidelines to safeguard members of the public from losing their savings and also ensure stability of the financial sector to enable the country attain targeted economic growth at 10 percent per annum.*

**JEL: O16**

**KEYWORDS:** Capital Markets, Corporate Governance, Financial Performance, Listed Banks, Unlisted Banks

## INTRODUCTION

Good corporate governance has become a subject of global interest because corporate entities play a vital role in promoting economic development through employment, wealth creation, as well as goods and services. Besides, good corporate governance is a pre-requisite for effective financial performance and greater autonomy (Matama, 2008; Colpan, Yoshikawa, Hikino and Miyoshi, 2007). In 2002, the Capital Markets Authority (CMA) developed a set of Guidelines on corporate governance to guide Kenyan listed companies in streamlining their corporate governance practices. The Guidelines were formulated in accordance with the provisions of sections 11(3) (v) and 12 of the Capital Markets Act (Cap. 485A). The Guidelines were also developed in response to the growing importance of corporate governance in promoting the growth of domestic and regional capital markets through better financial performance, capital formation and maximisation of shareholders' value (CMA, 2002; Matama, 2008).

Various management scholars have defined the concept of corporate governance in different ways. For instance, Fourier (2006) states that corporate governance is the tendency of leaders to conduct business within acceptable ethical standards. Abu-Tapanje (2005) explains that corporate governance promotes fair, efficient and transparent management of institutions to meet well-defined objectives through effective practices and structures. According to the CMA Guidelines, corporate governance is the process

of managing business affairs of an institution to achieve financial prosperity, accountability and improve shareholders' long-term value (CMA, 2002). The overall objective of the CMA Guidelines is to strengthen corporate governance practices among listed companies in Kenya. In this regard, the directors of such institutions should comply with good corporate governance practices, as part of their obligations to sustain their listing at the Nairobi Stock Exchange (NSE) market. The Guidelines outline various corporate governance principles, touching on structure and functions of the board of directors; the rights and responsibilities of shareholders; auditing and accountability, as well as public disclosure.

The CMA Guidelines should enhance sound economic growth through higher financial performance and capital formation to enhance the long-term value of shareholders (CMA, 2002). All listed corporate entities in Kenya should embrace good governance practices in line with provisions of the Guidelines, as a pre-requisite for their continued listing at the NSE. However, unlisted firms are encouraged to practice good corporate governance (CMA, 2002). This implies that listed and unlisted corporate entities in Kenya operate under different governance policy environments, which is likely to create variation in their financial performance and stability.

As noted by Murugu (2002), the collapse of a number of locally owned commercial banks in the 1990s was closely associated with a high portfolio of non-performing loans (NPLs) – a situation that ties to poor corporate governance practices. As at December 2001, prior to the launch of the CMA Guidelines, the banking sector had registered up to KES 215 billion in terms of NPLs, which accounted for up to 51 percent of the sector's net assets. Besides, the proportion of NPLs to the total loans in Kenya was at a high of 33 percent [Central Bank of Kenya (CBK), 2001]. As a result, the period between 1990 and 2005 saw the insolvency of a number of banks, including Euro Bank Limited, Trade Bank Limited, Daima Bank Limited, Transnational Bank Limited, Trust Bank Limited, Delphis Bank Limited, among others. It also marks the period when a number of state-owned banks such as Kenya Commercial Bank Limited and the National Bank Limited experienced serious financial performance challenges. Comparing the ratio of NPLs to total loans in Kenya of 33 percent to similar African economies at the end of 2001 the CBK supervision report notes that Zimbabwe had 24 percent, Nigeria registered 11 percent and South Africa 3 percent (CBK, 2001). This trend necessitated the formulation of appropriate regulatory measures, including the CMA guidelines to safeguard the interest of investors.

As at the time of this study, the CMA Guidelines had been operational for about eight years. The CBK's annual supervision report of 2009 indicated that the NPLs portfolio had reduced from by 65.6 percent from KES 215 billion in 2001 to about KES 74 billion (CBK, 2009). Although these statistics suggest that the banking sector has improved since the Guidelines came into existence, there is limited or no documentation regarding the role of the Guidelines in the improvement of financial performance in the banking sector. The few most recent studies focusing on the application of CMA Guidelines targeted the manufacturing and utility industries (Mutuku, 2005; Kiplangat, 2005; Gitari, 2005). The dearth of academic literature regarding the subject inspired the conduct of this study. To achieve its objectives, the study examined listed and unlisted commercial banks in terms of selected indicators of good corporate governance, including board size, proportion of non-executive directors, board maintenance cost and gender composition of the board. Additional indicators included the proportion of non-executive directors as well as the number of public disclosures in the immediate financial year. The study also determined the effect of each indicator of good corporate governance on the financial performance of commercial banks.

As noted by Kaheeru (2001), developing economies need good corporate governance practices to build resilient banking systems that would survive in an increasingly open business environment. Commercial banks play a crucial role in channeling citizens' savings into investments and providing necessary credits to the private sector. Hence, the stability and sustained growth of an economy closely links to the stability of its banking system (Matama, 2008). Good corporate governance is an indispensable pre-

requisite for the survival and high performance of corporate entities. In developing countries, corporate governance is particularly crucial in establishing the foundation for sustainable economic development (Matama, 2008). The CMA Guidelines therefore, aims at improving the capital market in the country, with a view to attracting and retaining investors to achieve economic growth.

The information yielded by this study should stimulate policy debate on the need for both public and private institutions to comply with CMA Guidelines to enhance their contribution to the national economy. In addition, the information improves existing literature on corporate governance and financial performance of corporate entities; thus, making the output a valuable resource material for business management scholars. The remainder of this paper contains six sections, including literature review, data and methodology, results, conclusions, limitations and areas of further research.

## **LITERATURE REVIEW**

Good corporate governance denotes a trend towards greater corporate responsibility and the conduct of business within acceptable ethical standards by which the board of directors and the senior management govern their behaviour [Private Sector Corporate Governance Trust (PSCGT), 2003]. The board of directors is at the core of institutional reforms towards good governance by formulating appropriate policies in line with prescribed standards such as the CMA Guidelines and ensuring that they are implemented (Fourier, 2006). Besides, well-governed corporate entities safeguard the rights of all stakeholders as well as focus on better financial and operational performance (PSCGT, 2003; Sanda, Mikailu and Garba, 2005).

Good corporate governance practices require institutions to establish strong and professional boards of directors that can make crucial decisions without bowing to pressure from the political class or other powerful stakeholders (Fourier, 2006). According to the CMA Guidelines, the board of directors should assume the primary responsibility of fostering long-term business interests of an institution, in line with their fiduciary responsibility to shareholders. In this regard, the board of directors should act on a fully-informed basis in defining institutional mission, goals, objectives, strategies and risk management plans; overseeing the management of all operations; reviewing performance, as well as identifying business opportunities, potential risks and appropriate measures to manage such risks (CMA, 2002; Cornford, 2007).

An effective board of directors should have an appropriate number of qualified and experienced members, nominated through documented procedures (Fourier, 2006). As part of good corporate governance, institutions should have documented policies on the procedures for establishing boards of directors in terms of size, gender composition, skill mix, experience, terms of office, removal and replacement (Cornford, 2007). Similarly, the CMA Guidelines prescribe that the board of directors should also develop an appropriate staffing and remuneration policy, including appointment of the chief executive and senior management staff (CMA, 2002).

The literature also shows that an effective board should consist of members sourced from other organisations to enhance independence and objectivity. Such board members may bring new perspectives from their respective organisations, which in turn, may improve the strategic direction given to the management team (PSCGT, 2003; Fourier, 2006). Similarly, the CMA Guidelines provide that the board of directors should have a balance of non-executive and executive directors. In this regard, non-executive directors should form at least one-third of the entire board. Nevertheless, the size of the board should not be too large to undermine an interactive discussion during board meetings or too small such that the inclusion of a wider expertise to improve board effectiveness is compromised (CMA, 2002). In addition, the board should have a structure that reflects the company's shareholding profile, including minority shareholders (CMA, 2002).

Additional key elements of good corporate governance include management of conflict of interest, role conflicts, as well as accountability and efficiency in the utilisation of resources. Also important is the formation of standing committees such as nomination to ensure that only qualified individuals are included in such boards; and audit committee to oversee implementation of auditing activities (Fourier, 2006; Cornford, 2007). Transparency is also crucial component of good corporate governance. It reduces information asymmetry between an institution's management and financial stakeholders (Ball, 2001; Sandeep, 2002). Disclosure is desirable in the following areas: board structure in terms of size, membership, qualifications as well as the structure of the senior management (PSCGT, 2003; Fourier, 2006). Disclosure is also desirable on the procurement process in terms of tendering methods, tender evaluation, award, as well as staff training and development [Kenya Institute of Public Policy and Research and Analysis (KIPPRA), 2006].

Good corporate governance can facilitate the attainment of higher financial performance of both private and public institutions. According to Matama (2008), financial performance has several dimensions, including capital adequacy, asset quality, returns on capital and share price among other parameters. Capital adequacy determines how well financial institutions can cope with shocks to their balance sheets. In commercial banks, capital adequacy is the relative risk weights assigned to the different category of assets held both on and off the balance sheet items (Fourier, 2006; Matama, 2008). Asset quality is an indicator of solvency. Financial institutions are usually at risk of solvency when their assets become impaired, so it is important to monitor indicators of the quality of their assets in terms of overexposure to specific risks such as NPLs (Fourier, 2006).

Credit risk arises when a borrower defaults on loan repayment agreement. A financial institution whose borrowers default on their repayments may face cash flow problems, which eventually affect its liquidity position and bears negative impacts on profitability (Matama, 2008). We can also measure financial performance in terms of returns on capital. In this regard, Matama (2008) argues that the continued viability of a bank depends on its ability to earn adequate returns on its capital. High returns on capital may enable a bank to fund its expansion, remain competitive in the market and replenish its capital. As noted by Abu-Tapanje (2005), a high financial performance in terms of returns on capital also ensures that shareholders reap higher dividends on their shares. Hence, high share prices reflect the level of returns on capital for a financial institution (Abu-Tapanje, 2005; Matama, 2008).

Various studies have linked corporate governance to financial performance of corporate entities. These include Matama (2008); Colpan, Yoshikawa, Hikino and Miyoshi (2007); Fourier (2006); Akodo and Moya (2005); Sanda, *et al.* (2005); Abu-Tapanje (2005), as well as Klapper and Love (2002), among others. These studies yielded mixed results depending on the elements of corporate governance and financial performance investigated. For instance, Colpan *et al.* (2007) assessed the corporate governance and financial performance of Japanese firms and found that while board size did not affect financial performance, the introduction of the position of a Chief Executive Officer (CEO) negatively influenced profitability. To support this finding, the authors argued that about 65 percent of the surveyed firms had not implemented the functional separation of boards and executive management. As such, the combination of smaller board size and executive management might have unexpectedly sharpened, rather than solved the 'agency problem' because the small number of top management executives dominated the decision-making process.

Bauer, Frijns, Otten and Tourani-Rad (2005) also assessed the importance of corporate governance for Japanese companies. Using data provided by Governance Metrics International, which rates firms on six different corporate governance categories, the study analyzed whether companies with a high governance ranking performed better compared to companies ranking low in terms of governance. Corporate performance was measured by share price, company value and operating performance. Using an overall index, the authors found that corporate governance positively affected share price and company value but

negatively affected operating performance. The authors also provided discussions of the findings regarding operating performance, for example, the possibility that companies with good governance applied prudent accounting policies, leading to more conservative financial reporting. In Jordan, Abu-Tapanje (2005) also found that increased strength of proper corporate governance in an organization exerted a positive influence on the operating and financial performance. Still in the region, Krambia and Psaros (2006) investigated the implementation of corporate governance principles in an emerging economy of Cyprus and the findings indicated minimal impact.

In Uganda, Akodo and Moya (2005) assessed the effect of corporate governance on the financial performance of selected public universities and found that board size and gender composition had a negative effect on financial performance while policy and decision-making roles had a significant positive relationship with financial performance. In addition, corporate governance had a significant positive relationship with board roles; while contingency had a significant positive relationship with board roles and effectiveness. The study concluded by emphasizing the need for public universities to formulate policies and make decisions that can stand the test of time. Still in Uganda, Masibo (2005) researched on board governance and the financial performance of selected State-Owned Enterprises (SOEs) and in listed organisations on Uganda Securities Exchange. The study obtained a positive direct and indirect link between board governance and firm performance through board effectiveness.

Matama (2008) also conducted a study to establish the relationship between the core principles of corporate governance and financial performance in commercial banks of Uganda. The study found that corporate governance predicted 34.5 percent of the variance in the general financial performance of commercial banks. However, the significant contributors to financial performance included openness and reliability, which are measures of trust. On the other hand, credit risk as a measure of disclosure had a negative relationship with financial performance. The study concluded that transparency and disclosure boosted the trustworthiness of commercial banks, hence the need for both local and international banks to enforce full transparency and disclosure practices to survive in the competitive financial landscape. In Nigeria, Sanda *et al*, (2005) found that there was a significant association between boards with a higher proportion of outside directors and financial performance. However, the study noted that organisations run by expatriate CEOs achieved higher levels of financial performance than those run by native CEOs.

Coombes and Watson (2002) surveyed over 200 institutional investors and found that 80 percent of the respondents would pay a premium for well-governed corporate entities. The size of the premium varied by market, from 11 percent for Canadian corporate institutions to around 40 percent for corporate entities operating in countries where the regulatory backdrop was less certain, such as Egypt, Morocco and Russia. The United Kingdom and United States scored 12 percent and 14 percent respectively. Although the study was opinion-based, the findings reflected a growing perception amongst market participants that well-governed corporate entities, which safeguard the interests of investors, may benefit from a lower cost of capital. In other words, investors favor companies, which they perceive to be organized.

The Deutsche Bank (2006) assessed the governance of the 350 companies listed in the Frankfurt Stock Exchange at the end of 2000, 2003 and June 2005 using 50 differently weighted corporate governance standards. It found a clear link between corporate governance and share price performance of the companies considered. During the four and a half year period investigated, the top 20 percent of the companies in terms of governance structure and behaviour outperformed those in the bottom 20 percent by 32 percent. Deutsche Bank also carried out a momentum analysis, which ranked companies, based on how their governance practices evolved over the period investigated.

The out-performance of the companies, which were consistently in the top 20 percent, as compared to the companies consistently in the bottom 20 percent, was 59 percent. Furthermore, the study found that companies, which improved from the lowest quintile, out-performed those companies that remained in the

lowest quintile by 7 percent. Deutsche Bank's research also showed that there was a positive relationship between the historic governance assessment of the companies and their profitability. For instance, the top 20 percent companies were significantly more profitable than the bottom 20 percent.

Gompers, Ishii and Metrick (2004) assessed the governance of 1,500 US companies using 24 governance provisions analysed by the Institutional Investors Research Centre (IRRC) and found that companies with a good corporate governance ranking were higher valued and had higher profits than those with lower ranking. Bebchuk, Cohen and Ferrell (2004) investigated which of the 24 governance provisions tracked by the IRRC correlated with company value and shareholder returns. They identified six such provisions: four concerning the extent to which a majority of shareholders can impose its will on the management and two relating to mechanisms that facilitate the defense of a hostile take-over.

Based on the findings, the authors constructed an entrenchment index and investigated the empirical relationship between this index and financial performance. They found that increases in the level of this index are consistently associated with economically significant reductions in the valuation of companies; and that companies with higher index levels were associated with significant abnormal returns during the 1990-2003 period. Most significantly, the study found that the six provisions on which the authors based the entrenchment index fully explained the correlation identified by Gompers *et al.* between the 24 IRRC provisions, reduced company value and lower share returns during the 1990s.

This study determined the influence of corporate governance on the financial performance of listed and unlisted commercial banks. While listed banks are under obligation to comply with CMA Guidelines, unlisted banks should practice good corporate governance (CMA, 2002). These two scenarios have the potential to influence financial results of listed and unlisted banks. The study focused on three pillars of corporate governance, viz. board structure and functions, auditing and accountability, as well as transparency and disclosure. I measured financial performance in terms of net returns on capital in the immediate financial year. As noted by Colpan, *et al.* (2007), net returns on capital is an appropriate measure of financial performance because it is applicable to both listed and unlisted organisations.

## DATA AND METHODOLOGY

Using the cross-sectional design, I sourced primary data from 16 commercial banks; 7 (43.8%) of which were listed at the NSE, while 9 (56.2%) were not listed. I collected data between May and July 2010 from senior managers after approval by their respective boards of directors. I stratified the sampling frame to ensure the inclusion of both local and international banks. However, based on the pre-study agreement with the banking institutions, their names remain confidential.

I performed quantitative analysis at the bivariate and multivariate levels. In bivariate analysis, I used one-way Analysis of Variance (ANOVA) to determine the statistical significance of variation between listed and unlisted commercial banks in terms of board size, proportion of non-executive directors, board maintenance cost and gender composition, proportion of non-executive directors as well as the number of public disclosures. Bivariate analysis also yielded Pearson's Correlation Co-efficient, denoted by letter  $r$ . This statistic measures the degree of correlation between interval-scaled variables. Its value lies between -1 and 1. When  $r = -1$  or  $1$ , then the correlation between two variables is perfect. The larger the absolute value of  $r$  the stronger the degree of correlation between the two variables.

In multivariate analysis, I applied multiple regression models to determine the effect of each indicator of good corporate governance on net returns on capital, while considering intermediate variables such as the number of account holders and bad debt portfolio. In general, form, multiple regression models take the premise that  $Y$  is a function of a set of  $k$  independent variables ( $X_1, X_2, \dots, X_k$ ) in a population (Bryman & Cramer, 1997).

$$Y_j = \beta_0 + \beta_1 X_{1j} + \beta_2 X_{2j} + \dots + \beta_k X_{kj} + E_j \tag{1}$$

Where,  $\beta_0$  is the intercept,  $\beta_1 \dots \beta_k$  is the partial regression co-efficients,  $E_j$  is the error term,  $Y_j$  is the dependent variable, while  $X_1 \dots X_k$  are the independent variables. In this study, the dependent variable ( $Y_j$ ) is net returns on capital, while the independent variables ( $X_1 \dots X_k$ ) included *board size, number of non-executive directors, cost of maintaining the board, number of female directors in the board, proportion of non-executive directors in the audit committee, and the number of public disclosures*. The Statistical Package for Social Sciences (SPSS) software package facilitated both bivariate and multivariate analyses. The following publications detail information on the research design, approaches and methods used in this study (Nachmias & Nachmias, 1996; Bryman & Cramer 1997; Mwanje, 2001).

## RESULTS

This section presents the descriptive, bivariate and multivariate analysis results. The elements of corporate governance injected in the analysis include board size, proportion of non-executive directors, board maintenance cost and gender composition of the board as well as the number of public disclosures. Board size refers to the number of directors serving in the boards of commercial banks within the immediate financial year. According to the CMA Guidelines, board size should neither be too large to undermine deliberations and costly to maintain; nor should it be too small to compromise skill diversity and expertise. In this regard, the Guidelines suggest a board size ranging between 7 and 11 members. In this regard, table 1 below presents bivariate analysis results while table 2 provides summary of the one-way ANOVA results.

Table 1: Board Size, Composition and Maintenance

Indicator		N	Mean	Std. Deviation	Std. Error	Min	Max
Number of board members	Listed	7	8.712	1.380	0.522	7	11
	Unlisted	9	11.886	1.764	0.588	9	15
	<b>Total</b>	<b>16</b>	<b>10.500</b>	<b>2.251</b>	<b>0.563</b>	<b>7</b>	<b>15</b>
Number of non-executive directors	Listed	7	5.291	1.604	0.606	3	8
	Unlisted	9	3.000	1.936	0.645	1	7
	<b>Total</b>	<b>16</b>	<b>4.001</b>	<b>2.098</b>	<b>0.524</b>	<b>1</b>	<b>8</b>
Number of female directors	Listed	7	2.433	1.397	0.528	0	4
	Unlisted	9	1.224	1.202	0.401	0	3
	<b>Total</b>	<b>16</b>	<b>1.747</b>	<b>1.390</b>	<b>0.348</b>	<b>0</b>	<b>4</b>
Cost of board maintenance (million KES)	Listed	7	52.000	44.423	24.587	24	85
	Unlisted	9	126.78	77.298	29.099	91	360
	<b>Total</b>	<b>16</b>	<b>85.305</b>	<b>34.410</b>	<b>53.603</b>	<b>24</b>	<b>360</b>

*This table presents the descriptive analysis results, showing a comparison of listed and unlisted commercial banks in terms of the selected outcome indicators of corporate governance, listed in the first column. The descriptive statistics presented in the table includes the sample size (N), the mean, standard deviation, standard error, as well as the minimum (MIN) and maximum (MAX) scores for each group of banks.*

The results in table 1 shows that listed banks had an average of 8.7 directors in their boards, while unlisted banks reported an average of 11.9 directors. To test if the difference between the two groups of banks in terms of mean number of directors, the ANOVA results presented in table 2 yielded a calculated F-statistic of 15.297, this was significant at 0.01 error margin. This suggests up to 99 percent chance that listed and unlisted commercial banks were significantly different in terms of board size.

Table 2: Summary of ANOVA Results

Indicator		Sum of Squares	Df	Mean Square	F	Sig.
Number of board members	Between Groups	39.683	1	39.683	15.297	0.002***
	Within Groups	36.317	14	2.594		
	<b>Total</b>	<b>76.000</b>	<b>15</b>			
Number of non-executive directors	Between Groups	20.571	1	20.571	6.340	0.025**
	Within Groups	45.429	14	3.245		
	<b>Total</b>	<b>66.000</b>	<b>15</b>			
Number of female directors	Between Groups	5.730	1	5.730	3.447	0.085*
	Within Groups	23.270	14	1.662		
	<b>Total</b>	<b>29.000</b>	<b>15</b>			
Cost of board maintenance (million KES)	Between Groups	1,300,830	1	1,300,830	48.355	0.000***
	Within Groups	376,626	14	26,902		
	<b>Total</b>	<b>1,677,455</b>	<b>15</b>			

*This table presents the summary of ANOVA results for four elements of corporate governance. ANOVA is an important technique of examining the extent of difference between any two groups in terms of selected outcome indicators. The third column from left shows the regression sum of squares between and within groups. The fourth column is the degrees of freedom (DF); the next column is the regression mean squares between and within groups. The SPSS program generates F-statistic and associated p-values. The significance or p-value shows whether the difference observed between any two groups is statistically significant or not. \*\*\*, \*\* and \* shows the level of significance at 1, 5 and 10 percent respectively.*

The CMA Guidelines encourages a balance between the executive and non-executive directors in the board. This provision arises from the premise that non-executive directors provide a useful check to the activities of executive directors. A strong composition of non-executive directors ensures that executive directors act within set guidelines and ensures that the latter group is accountable for their actions. The Guidelines specifies that non-executive directors should form at least one-third of the boards of companies. The results in table 1 shows that listed banks had an average of 5.3 non-executive directors, while the unlisted banks reported an average of three such people. In this regard, the ANOVA results obtained a calculated F-statistic of 6.340, which is significant within 0.05 error margin. This implies a probability of up to 95 percent that listed and unlisted commercial banks were significantly different in terms of the number of non-executive directors.

The CMA Guidelines advocates for the engendering of boards of directors; in other words, effective boards should reflect the structure of shareholders in terms of gender composition. Hence, women should form at least one-third of the boards of directors, as a sign of good corporate governance practice. The findings presented in table 1 above show that listed banks had an average of 2.4 women directors, while unlisted banks reported an average of one-woman director. Although, the results reveal a significant difference in women's involvement in the boards of listed and unlisted commercial banks, it is important to note that no group had attained the one-third minimum threshold advocated for by the Guidelines. Furthermore, the ANOVA results in table 2 indicate that listed and unlisted banks were significantly different in terms of the number of women directors.

The cost of board maintenance is another critical indicator of good corporate governance upon which the Guidelines focus. The variable refers to the amount of financial resources used to maintain the board of directors within the immediate financial year, in terms of allowances. Sustaining a board of directors can be overwhelming, especially in situations where an institution registers low returns on capital. The cost of board maintenance directly correlates with board size and can have serious implications on net returns on capital, particularly where such boards are inefficient in decisions, strategies and resource utilization. The results summarized in table 1 above show that listed banks spent an average of KES 52,000,000 on board maintenance costs, while unlisted banks reported an average of KES 126,000,000. These results suggest that unlisted banks spent about twice as much as listed banks in maintaining the activities of their



respective boards of directors. More still, table 2 shows that the analysis obtained a calculated F-statistic of 48.355, which was significant at 0.01 error margin. This implies up to 99 percent chance that listed and unlisted banks were significantly different in terms expenditure level on board maintenance.

The number of non-executive directors as a ratio of the total directors, who served in the audit committee in the immediate financial year is one of the factors likely to influence the level of financial transparency in corporate governance. The CMA Guidelines indicate that audit committees should consist of at least three non-executive directors, which is crucial in enhancing transparency and ensuring that excesses of executive directors are checked. In this regard, table 3 below shows that listed banks reported an average of 1.8 non-executive directors in the audit committees, while unlisted banks had an average of less than one such director. In table 4, the analysis obtained a calculated F-statistic of 8.429, which was significant at 0.05 error margin. This implies that the two groups of commercial banks were significantly different in terms of the inclusion of non-executive directors in their respective audit committees.

Table 3: Accountability and Transparency Indicators

Indicators		N	Mean	Std. Deviation	Std. Error	Min	Max
Number of non-executive directors in the audit committee	Listed	7	1.86	1.069	0.404	0	3
	Unlisted	9	0.56	0.726	0.242	0	2
	Total	16	1.12	1.088	0.272	0	3
Number of public disclosures	Listed	7	2.71	1.113	0.421	1	4
	Unlisted	9	0.44	0.527	0.176	0	1
	Total	16	1.44	1.413	0.353	0	4

*This table presents descriptive analysis results, comparing listed and unlisted commercial banks in terms of the number of non-executive directors in the audit committee as well as the number of public disclosures in the preceding financial year. The table shows the sample size (N), the mean, standard deviation, standard error, as well as the minimum (MIN) and maximum (MAX) scores.*

Good corporate governance is achievable through regular disclosures to stakeholders and shareholders to expedite corrective measures for negative issues likely to affect financial performance. Table 3 indicates that listed banks had done an average of 2.7 public disclosures of their financial reports arising from continuous monitoring and evaluation activities, while the unlisted banks had disclosed their financial reports fewer than once over the preceding financial year. Further analysis results presented in table 4 suggest a probability of up to 99 percent that listed and unlisted banks were significantly different in terms of the frequency of disclosure of their financial reports.

Table 4: Summary of ANOVA Results

Indicators		Sum of Squares	Df	Mean Square	F	Sig.
Number of non-executive directors in the audit committee	Between Groups	6.671	1	6.671	8.429	0.012**
	Within Groups	11.079	14	0.791		
	Total	17.750	15			
Number of public disclosures	Between Groups	20.287	1	20.287	29.429	0.000***
	Within Groups	9.651	14	0.689		
	Total	29.938	15			

*This table presents the summary of ANOVA results for two indicators of good corporate governance. The results show that listed and unlisted commercial banks were significantly different in terms of the proportion of non-executive directors in the audit committee, as well as in terms of the frequency of disclosure of t information. \*\*\*, \*\* and \* shows the level of significance at 1, 5 and 10 percent respectively.*

I measured financial performance in terms of net returns on capital during the immediate financial year. ‘Net returns on capital’ refers to net income after taxation for both listed and unlisted commercial banks. In this regard, table 5 presents the descriptive statistics regarding net returns on capital, where the results

show that listed banks recorded an average of KES 421,000,000 net returns on capital, while unlisted banks reported an average of KES 319,000,000.

Table 5: Net Returns on Capital

Indicator		N	Mean	Std. Deviation	Std. Error	Min	Max
Net returns on capital (million KES)	Listed	7	421.14	86.713	32.774	344	591
	Unlisted	9	319.00	80.759	26.920	135	497
	Total	16	307.44	131.20	32.799	135	591

*This table shows the descriptive analysis results for the net returns on capital [in million Kenya Shillings (KES)]. The results indicate that listed banks recorded an average of KES 421,000,000 net returns on capital, while unlisted banks reported an average of KES 319,000,000. Consequently, listed banks were likely to be performing better than those not listed.*

Table 6: Summary of ANOVA Results

Indicator	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	160,893	1	160,893	23.152	0.006***
Within Groups	97,291	14	6,949.4		
Total	258,184	15			

*This table indicates the summary of ANOVA results, which suggest that listed and unlisted commercial banks were significantly different in terms of net returns on capital. In other words, listed banks were likely to be having higher returns on capital than unlisted banks. \*\*\*, \*\* and \* shows the level of significance at 1, 5 and 10 percent respectively.*

Furthermore, the one-way ANOVA obtained a calculated F-statistic of 23.152, as indicated in table 6 above. This result is significant at 0.01 error margin, which in turn, implies up to 99 percent chance that listed and unlisted banking institutions were significantly different in terms of net returns on capital. In addition, using Pearson’s Correlation Coefficient r, each element of corporate governance correlates with net returns on capital to determine financial performance. The value of r usually lies between -1 and 1. When r = -1 or 1, then the correlation between two variables is likely to be perfect. The larger the absolute value of r the stronger the degree of correlation between any two variables. Table 7 below presents a summary of r results for each of the outcome indicator.

Table 7: Summary of Pearson’s Correlation Co-efficient Results

Indicator	Calculated R	N	Sig.
No. of board members	-0.505	16	0.046**
No. of non-executive directors	0.588	16	0.017**
No. of female directors	0.706	16	0.002***
Cost of board maintenance	-.429	16	0.179
No. of non-executive directors in audit committee	0.491	16	0.053*
Frequency of disclosure	0.665	16	0.013**

*This table shows the Pearson Correlation Coefficients for each of the outcome indicator of corporate governance. The first column shows the indicators, the second column presents the calculated r, sample size (N) and p-values (SIG.). The value of r lies between -1 and 1. When r = -1 or 1, then the correlation between two variables is perfect. The larger the absolute value of r the stronger the degree of correlation between the two variables. \*\*\*, \*\* and \* shows the level of significance at 1, 5 and 10 percent respectively. For instance, the number of board members significantly correlated with net returns on capital at 5 percent error margin.*

The results in table 7 show that all the indicators of corporate governance significantly correlated with the financial performance of commercial banks, except the cost of board maintenance. Besides, variables such as the number of board members and cost of board maintenance negatively correlated with net returns on capital (financial performance). Although bivariate analysis is important in the determination of how independent variables correlate with the dependent variable, it cannot bring out the net effect of each independent variable. For instance, Pearson’s Correlation Co-efficient cannot tell whether variation

in board size had a decreasing or increasing effect on the financial performance of commercial banks. This necessitated the application of a multivariate analysis technique – multiple regression analysis. In this regard, the independent variables incorporated in the multiple regression model included board size, number of non-executive directors, proportion of female directors, cost of board maintenance, number of non-executive directors in the audit committee and frequency of public disclosures. Table 8 below presents a summary of multiple regression results.

Partial regression co-efficients ( $\beta$ ) signify the strength and effect of each factor. Whereas the sign before  $\beta$  indicate the direction of influence, the value of regression co-efficients shows the strength of effect. A negative (-) regression co-efficient shows a negative effect (reduction) on financial performance, while a positive regression co-efficient shows a positive (incremental) effect on financial performance. However, to facilitate comparison of background variables in terms of their effect on the timing of first marriage, SPSS standardizes the regression co-efficients to generate *Beta weights*. Beta weights essentially tell by how many standard deviation units the dependent variable is likely to change for a unit standard deviation change in an independent variable. In addition, *t* values under the *t* column represent that statistical significance of the effect for each background variable.

Table 8: Summary of the Regression Analysis

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	$\beta$	Std. Error	Beta		
(Constant)	112.46	228.7		0.492	0.035**
Number of board members	-5.130	22.265	-0.642	-0.236	0.015**
Number of non-executive directors	10.632	16.914	0.170	0.629	0.011**
Number of female directors	49.714	26.680	0.527	1.863	0.000*
Cost of board maintenance	-0.014	0.149	-0.036	-0.094	0.287
Number of non-executive directors in the audit committee	1.873	41.420	0.016	0.045	0.135
Number of public disclosures	36.488	38.958	0.393	0.937	0.003*

*This table presents a summary of multiple regression results. The first column shows the variables entered into the equation. The analysis method was forward stepwise. Partial regression co-efficients ( $\beta$ ) indicate the strength and direction of effect for each factor. Whereas the sign before  $\beta$  indicate the direction of effect, the value of the regression co-efficients signifies the strength of effect. \*\*\*, \*\* and \* shows the level of significance at 1, 5 and 10 percent respectively.*

The results show that gender composition of the boards had the strongest positive influence on the financial performance of commercial banks. Consequently, increasing the number of female directors in the boards would cause a proportionate improvement in financial performance of commercial banks. The effect of this factor is significant at 0.01 error margin. The number of public disclosures of financial reports also had a strong positive influence on the financial performance of commercial banks. The results further show that the influence of this factor is significant at 0.01 error margin. Public disclosure is a critical element of transparency and has positive effects on the level of trust and confidence among stakeholders, including clients and shareholders. In turn, the level of trust and confidence bestowed on a banking institution is an indispensable for its natural marking and expansion of the business horizon.

Another variable with a strong positive influence on the financial performance of commercial banks is the board composition in terms of executive and non-executive directors. The influence of this factor is significant at 0.05 error margin. The kind of check provided by non-executive directors against excesses of executive directors is likely to enhance accountability and trust in the eyes of stakeholders. This is likely to have a positive influence on the financial performance. In view of this, increasing the proportion of non-executive directors in the board is likely to cause a proportionate improvement in financial performance.

The number of non-executive directors in the audit committee also returned a positive influence on the financial performance of commercial banks. However, its influence of this factor is not significant at any point within the 0.01 error margin. This suggests the number of non-executive directors on net returns on capital was insignificant, at least with the sample of banks involved in this study. The results in table 8 further show that the number of board members had a strong negative influence on the financial performance of commercial banks. This suggests that increasing the board size would result to a proportionate decrease in net returns on capital and vice versa. The influence of this variable is significant at 0.05 error margin. The influence of this variable is significant at 0.05 error margin. The cost of board maintenance returned a weak negative influence on the net returns on capital; suggesting that increasing the cost of maintaining the board is likely to cause a proportionate decline in net returns on capital. However, the influence of this variable is not significant at any point within the 0.1 error margin.

The coefficient of determination ( $R^2$ ) indicates the explanatory power of the model. However,  $R^2$  often adjusts for the number of independent variables included in the model. The analysis used in this study obtained an  $R^2$  of 0.687, suggesting that the model was able to explain up to 68.7 percent of variance in the net returns on capital for commercial banks involved in the study. However, when this adjusts to take care of independent variables used in the study, the adjusted  $R^2$  reduced to 0.478, which means the adjusted model explained up to 47.8 percent of variance in the net returns on capital for commercial banks. The associated ANOVA yielded a calculated F statistic of 3.293 and a p-value of 0.053, which shows that the model was significant at 0.1 error margin.

## CONCLUSIONS

The goal of this study was to determine the influence of CMA's Guidelines on good corporate governance on the financial performance of the Kenyan commercial banks. To achieve this goal, the study covered a set of commercial banks listed at the NSE and another set of unlisted banks. Whereas listed banks have no choice about aligning their governance structures and operations with CMA guidelines, unlisted banks have no such obligation. This creates two different policy environments, which have the potential to shape the financial performance of commercial banks in the two scenarios. I sourced primary data from 16 commercial banks, seven of which traded at the NSE. I used one-way ANOVA and Pearson's Correlation Co-efficient ( $r$ ) in bivariate analysis and multiple regression analysis to determine the effect of corporate governance factors on the financial performance of commercial banks.

Bivariate analysis results indicate that commercial banks operating in the two settings were significantly different in terms of key governance indicators, including board size, proportion of executive and non-executive directors, gender composition, cost of board maintenance, composition of audit committees and the frequency of financial disclosures. Although the findings suggest that listed commercial banks were adhering to the CMA Guidelines more than unlisted banks, some indicators such as gender composition and composition of audit committees suggest that neither group had attained the minimum threshold prescribed by the Guidelines.

Multivariate analysis found that gender composition of the boards had the strongest positive influence on the financial performance of commercial banks. Hence, increasing the number of female directors in the boards is likely to improve the financial performance of commercial banks. The number of public disclosures of pertinent information is another variable having a strong positive effect on the financial performance of commercial banks. Next in line was board composition in terms of executive and non-executive directors, and the number of non-executive directors in the audit committee. Contrastingly, the number of board members had a strong negative effect on the financial performance of commercial banks, followed by the cost of board maintenance.

Overall, the regression model generated by the study explained up to 47.8 percent of variance in the financial performance of commercial banks, as indicated by the co-efficient of determination. Nonetheless, the results indicate that listed banks recorded better financial performance than those unlisted, an achievement that was attributable to conformity and alignment with the Guidelines. Consequently, the value of the CMA Guidelines on good corporate governance remains important for the stability and sustained growth of the financial sector in the country.

The national economic development blueprints such as the Vision 2030, have documented the national desire to achieve an economic growth rate of at least 10 percent per annum by the year 2020. The blueprints also articulate the strategies through which a sustained growth rate of the national economy is achievable, which include good corporate governance. There is no doubt that the corporate sector has a crucial role to play in Kenya's quest for a sustained economic growth as envisaged in the blueprints. The financial institutions are particularly very instrumental in mobilizing savings and financing investments. The stability of the financial sector is therefore, of great importance to economic stability and growth at the national level. However, how well the corporate sector fulfils its expectation largely depends on the effectiveness and efficiency of governance structures. Whereas well-organized and streamlined governance can propel organizations to the greatest height of success, poor governance practices can bring down some of the world's mightiest corporate bodies.

The financial sector is particularly very sensitive to poor governance. In the past, a number of commercial banks such as Trust Bank Limited, Trade Bank Limited, Daima Bank Limited and Trans-National Bank Limited, just to mention but a few, have collapsed and sunk with millions of Kenya Shillings. Forensic analysis of commercial banks' liquidation reveals serious issues, but which are avoidable through good corporate governance practices. It is therefore, important that the Government of Kenya should enact a legal framework to enforce alignment with CMA Guidelines on good corporate governance, especially by corporate entities entrusted with financial resources belonging to members of the public. Such a move will not only safeguard members of the public from losing their savings, but also and more importantly, ensure stability of the financial sector to enable the country attain the targeted economic growth at 10 percent per annum.

### Limitations

The financial sector is sensitive to negative public opinion. Consequently, most financial institutions are closed; hence, they rarely share their information with outsiders, particularly due to suspicion. In view of this, most commercial banks were unwilling to take part in the study, and even those that consented were not free to share information comprehensively. This challenge limited the comprehensiveness of qualitative information sourced. Under such circumstances, the researcher terminated interviews that were less fruitful and information sourced from such institutions eliminated from the analysis. This however, reduced the sample size to only 16 institutions, which then is likely to affect the robustness of results. A small sample size also limits the choice of analysis tools. Another limitation linked to the sensitivity of the financial sector is scarcity of academic literature linking corporate governance and financial performance of commercial banks, especially in Kenya. Consequently, this study relied on empirical literature from other countries to inform its conceptualization.

### Further Research

Good corporate governance is indispensable in the process of building resilient banking systems and for developing a strong foundation for sustainable development. Commercial banks are at the centre of economic growth and stability. Although poor corporate governance practices ties with the rampant failure and liquidation of commercial banks between 1990 and 2005, such incidents cannot entirely be delinked from political leadership and the democratization processes, particularly the advent of multiparty

democracy in Kenya. Available anecdotal evidences tend to fuse the collapse of some banks with the political leadership and processes at that time. This area remains under-documented in academic circles; hence, future studies should consider exploring the nexus between political leadership, democratization and performance of commercial banks not only in Kenya, but also in other developing economies.

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### **ACKNOWLEDGEMENT**

I am grateful to the University of Nairobi for financing the study. I also thank my research team, particularly Tom Odhiambo and Fredrick O. Apopa. I am indebted to all the chief executive officers of commercial 16 commercial banks involved in this study. Finally, I thank my colleagues, Tom Odhiambo and Paul Odundo for reviewing and validating the contents of this paper.

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