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EFFECT OF CORPORATE GOVERNANCE ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA: CASE STUDY OF CHASE BANK KENYA

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Abstract

Governance in many institutions remains an essential issue as a means to increasing shareholder value and demonstrating the readiness and capability of management to lever this issue. Kenya's banking industry in the latest past has been on the lime light with some big banks, which were deemed to be performing being put under receivership on what has been attributed to weak corporate governance. This study sought to know the effect of the various governance variables on financial performance by way of a case study research of Chase bank in Nairobi, Kenya. Four variables including board characteristics, internal controls, ownership and risk management were used to establish the extent to which corporate governance impacted the overall financial performance of commercial banks. The study employed a descriptive research design embracing the use of structured questionnaires. The questionnaires designed were issued to respondents with an aim to collect information on how the bank was governed. The data was obtained from 69 members of staff, which included the top management team and the relevant department, who were all administered with the questionnaires. The research instrument was then pilot tested for reliability and validity. The analysis was done using descriptive statistics such as mean scores, frequencies and percentage. Pearson correlation technique was used to establish the strength and significance of the relationship of board characteristics, ownership, internal controls and risk management and financial performance in commercial banks in Kenya. Field study was done and the data analyzed and discussed to come up with a conclusion which helped the study to give commendation to the concerned parties. The study found out that board characteristics positively influenced the financial performance at Chase bank Kenya. In addition, consideration of the bank's ownership ensured improved financial performance. Internal controls and risk management were also identified as key to good governance which guaranteed enhanced financial performance. The study thus recommends that in order to guarantee improved financial performance the commercial banks need proper governance practices.

Key Words: Corporate governance, Board characteristics, Internal Controls, Risk Management, Ownership.

1.0 Introduction

The banking sector has been severely criticized for its role in the recent financial crisis. Notably, the weak governance of banks is often identified as a major cause of the crisis (Kirkpatrick, 2009). In the UK, Sir David Walker was commissioned to recommend measures to improve board-level governance at banks to the government (Walker, 2009). There is no comprehensive and uniform definition of good governance, there have been attempts by scholars, the United Nations and International Financial institutions to expound the notion (Chowdhury & Skarstedt, 2005). The World Bank Institute (1999) defines governance as the traditions and institutions by which authority in a country is exercised for the common good.

Poor corporate governance of the banks can drive the market to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a liquidity crisis and then it might lead to economic crisis in a country and pose a systemic risk to the society at large (Alexander, 2006, Garcia-Marco & Robles-

Fernandez, 2008). Grindle (2008) posits that most of the good governance agenda is about what governments need to do to put their political, administrative and financial houses in better order. Understanding the corporate governance of banks is especially important because of the systematic risk that banking activity poses for the economy at large as evidenced by the U.S. savings and loan crisis in the 1980's, the Asian financial crisis in the 1990's, and the more recent subprime mortgage crisis (Alexander, 2006).

The subject of corporate governance in Kenya has remained on top of the agenda for many years. Despite tight regulatory framework, corporate governance continues to deteriorate in Kenya to some level. Kenya in particular, concern was raised specifically on the way in which organizations were managed and controlled. According to Centre for Corporate Governance of Kenya (CCG) (2016), focus on corporate governance in the financial sector is crucial mostly because the banking industry became highly exposed to scrutiny by the public and many lessons were learnt because of the risks involved including adverse publicity brought about by failings in governance and stakeholder relations for instance, the collapse of banks such as Euro bank, Trust bank and Daima bank just to mention a few cases (CCG, 2004).

1.2 Problem Statement

With banks, regulation is a constraint that shareholders have to satisfy. Given the constraint, shareholders still want to maximize their wealth, and hence a well- governed bank should have mechanisms in place so that the level of risk chosen by management maximizes shareholder wealth subject to the constraints imposed by regulation. First, evidence shows that banks with boards that were more shareholder friendly performed worse than other banks (Beltratti & Stulz, 2012).Second, the governance literature emphasizes that more stock ownership by top management leads to better placement of incentives between management and the shareholders. However, existing evidence shows that banks where management had more of a stake performed worse during the crisis (Fahlenbrach & Stulz, 2011). Third, there is a considerable literature that focuses on CEO's ability to entrench themselves so that they can pursue their own objectives rather than maximize shareholder wealth. Such entrenched CEOs are likely to take less risk than shareholders would like them to because they could lose their job if the bank they lead experiences distress. Ferreira, Kershaw, Krichmaier, and Schuster (2013) posits that managers of banks that were more entrenched were less likely to be bailed out during the crisis. Chen, Hong and Scheinkman (2010) posit that institutional investors preferred banks that were taking more risk before the crisis. Finally, there is no evidence that banks whose board had more financial expertise performed better (Minton, Taillard & Williamson, 2014).

Locally, there are a few studies in corporate governance though none has focused on commercial Banks. Muriithi, (2009), many companies have been characterized by scandals. Directors have acted illegally or in bad faith towards their shareholders. Indeed, the Insurance Regulatory Authority identified poor Corporate Governance in insurance Companies as one of the threats to achieving its strategic plan 2008-2012. From the published annual financial reports, some commercial banks in Kenya recorded unpleasant performance in the early 2000 but there has been significant improvement since 2007 and this study is therefore, designed to establish the effect if any of corporate governance on financial performance of Commercial Banks in Kenya.

Mukanyi (2011), corporate governance continues to deteriorate even though there is a tight regulatory framework. Muriithi (2009), asserts that many companies in Kenya have been characterized with scandals of different levels and magnitudes. The Insurance regulatory authority also identified poor corporate governance as a challenge to achievement of strategic plan 2008-2012. A study conducted by Guze (2012) on the effect of corporate governance on performance of public corporations in Kenya established that corporate governance plays a major role in determining the level of performance.

There is a yawning gap that exists since none of them covers effects of corporate governance on financial performance precisely in the commercial banking sector in Kenya. The only study done in Kenya by the Centre for Corporate Governance focused on governance practices in the commercial banking sector in Kenya. It was against this background that the researcher found it necessary to carry out a study on ownership structure and corporate governance and its effects on performance in the Kenyan commercial banking sector to bridge the gap that existed. This research therefore target to provide a conclusive requirement to have governance with tried strategies to be adopted by financial institution to enhance financial performance.

1.3 Research objective

- Determine the effect of board characteristics on financial performance of Chase bank.
- Establish the effect of bank ownership on financial performance of Chase bank.
- Determine the effect of internal controls on the financial performance of Chase bank.
- Determine the effect of risk management on the financial performance of Chase bank.

2.0 Research Methodology

The study adopted a case study research design to determine the effect of the various governance characteristics on the overall performance of commercial banks. The banking sector is preferred due to its importance in Kenya towards achieving the economic pillar of Vision 2030. Restricting attention to firms in a single industry helps to reduce inter- industry heterogeneity. The target population of the study was Chase Bank in the Republic of Kenya which has its headquarter in Riverside, Nairobi. The bank has several branches in the country but the target population was its headquarters from where the top management sit. The study population was 80 staff members of the top management team at the Chase bank during the calendar year 2017. For the study, a census survey was desirable because the target population was not so large and this ensured a high degree of accuracy.

The study used primary data collected by use of structured questionnaires in its analysis. The data was collected using online and drop and pick method. The structured questions were used so as to facilitate in easier analysis as they are in immediate usable form. The data collected was then subjected to analysis using a statistical tool. The study adopted quantitative approach for data analysis. SPSS (V21) statistical software version was used to run descriptive statistics such as frequency and percentages to present the data in form of tables and graphs based on the major research questions. The study then adopted a multiple regression model with 5% level of significance in order to establish the strength of the relationship between the independent variables (Board characteristics, bank ownership, internal control and risk management) and the dependent variable (financial performance).

2.1 Model Specification

For the variables under investigation, it was fit to have the following model to help explain the relationship between the explanatory variables and the main response variable (Bank financial performance)

$$Y = \beta_0 + \beta_1\chi_1 + \beta_2\chi_2 + \beta_3\chi_3 + \beta_4\chi_4 + \varepsilon$$

Y=Financial performance

β_0 = Coefficient of the main model

$x1$ = Board characteristics

$x2$ = bank ownership

□3 = Internal control

□4 = risk management.

e = error term associated with bank financial

performance

Findings and Discussion.

2.2 Discussion of Results

2.2.1 Demographic Characteristics of the Respondents

The results from the study revealed that majority (59.4%) of the respondents have worked in the bank for over 5 years, 18.8% of the respondents have worked for 4 years, 7.2% of the respondents have an experience of 3 years and 14.5% have an experience of 1 year and below. This results indicates that majority of the respondent who involve in the study have worked in the banking sector for over 5 years. This implied that Chase bank has an effective staff retention policy.

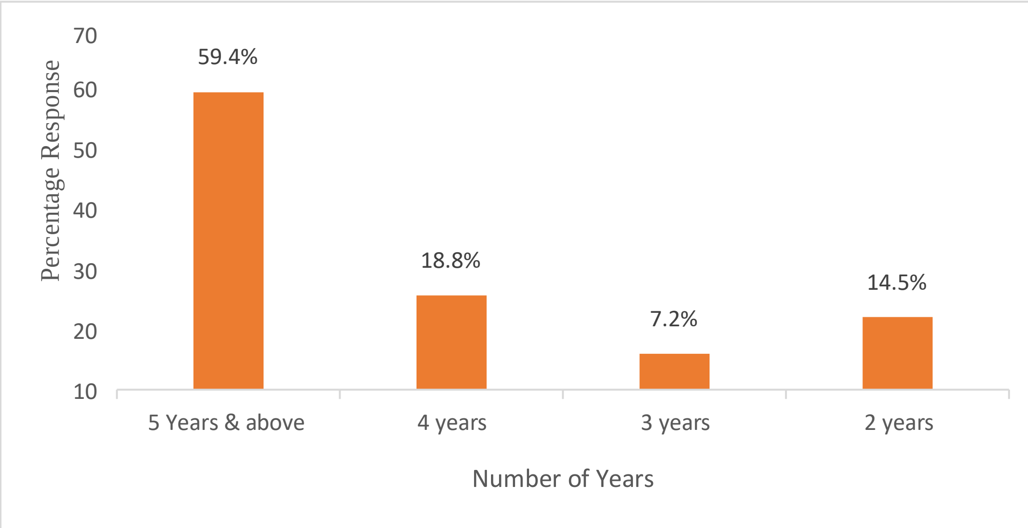

Figure 1: Work Experience

2.2.2 Regression Analysis

The study adopted a multiple regression analysis so as to test the relationship among variables (independent) on the financial performance of Chase Bank. The results presented in Table 1 present the fitness of model used for the regression model in explaining the study phenomena .Board characteristics, Ownership, Internal Control and Risk Management explained 52.1% of variation in Financial Performance of Banks in Kenya.

Table 1: Model fitness

Indicator	R	R-Squared	Adjusted R-Squared	Std. Error of the Estimates
Coefficient	0.722	0.521	0.491	0.13167

R is the correlation coefficient which shows the relationship between the independent variables and dependent variable. It is notable that there exists strong positive relationship between the independent variables dependent variable (Financial performance) shown by the R value (0.722). The coefficient of determination (R-Squared) explains the extent to which changes in dependent variable (Financial Performance) can be explained by the changes in the independent variables or the percentage of variation in the dependent variable and the four independent variables that were studied explain 52.1% of the change in financial performance represented by R- squared. This therefore means that other factors not studied in this study contribute 47.9% of the financial performance of commercial banks. The study therefore identifies the variables studied as critical determinants of financial performance

Table 2: Analysis of Variance

	Sum of Squares	**df**	**Mean Square**	**F**	**Sig.**
Regression	1.204	4	.302	17.419	.000
Residual	1.110	64	.017		
Total	2.317	68			

Table 2 provides the results on the analysis of the variance (ANOVA). The results imply that X1, X2, X3 and X4 are good predictors of Financial Performance of Banks. This was supported by an F statistic of 17.419 on 4 and 64 degrees of freedom and the reported p value (0.000) which was less than the conventional probability of 0.05 significance levels. This results indicates that the overall model fitted on the data is statistically significance.

Table 3: Regression of Coefficient

Variable	**B**	**Std Error**	**t**	**sig**
(Constant)	.688	.288	2.389	.000
Board characteristics	.491	.106	4.632	.000
Ownership	.460	.125	3.680	.000
Internal Control	.683	.187	3.657	.000
Risk Management	1.679	.234	7.177	.000

From Table 3, the specific model was; $Y=0.688+0.491X1+0.460X2+0.483X3+1.679X4$

Where X1-Board characteristics, X2-Ownership, X3- Internal Control and X4-Risk Management and Y is the Financial Performance.

This results indicates that both Board characteristics, Ownership, Internal Control and Risk Management have a significant positive effect on the Financial Performance of Banks. This implies that a unit increase in Board characteristics, Ownership, Internal Control and Risk Management will lead to 0.491, 0.46, 0.683, and 1.679 respectively improvement in Financial performance of Banks in Kenya.

Discussion of the results Board characteristics

Table 3 indicates that, more than 70% on average of the respondents were in agreement that board characteristics was responsible for improved financial performance. From the majority respondent opinion it can therefore be concluded that board characteristics plays a significant role in enhancing financial performance among commercial banks in Kenya. This is supported by a regression coefficient of $\beta 1 = 0.491$ (p-value = 0.000 which is less than $\alpha = 0.05$). This therefore concurs with Guest (2008) study which found out that board composition was significantly associated with firm performance. Wambua (2011), a study on effect of corporate governance on financial performance of Sacco's in Kenya found out that 59% of the respondents agreed that board size and composition affected the financial performance in the Sacco to a small extent.

Ownership

Table 3 reveals that of the 69 respondents on average 70% agreed that ownership as a predictor of good governance enhances the financial performance of Chase bank. This is supported by a regression coefficient of $\beta 1 = 0.491$ (p-value = 0.000 which is less than $\alpha = 0.05$). We can therefore draw a conclusion that putting into consideration in managing the bank ensures a positive influence on the financial performance of commercial banks in Kenya. Dadson (2012) did a study on concentrated share ownership and financial performance of listed companies in Ghana. The findings showed that share ownership on the Ghana Stock Exchange is heavily concentrated in the hands of Ghanaians and that ownership concentration, institutional and insider ownership precipitate higher firm financial performance. The findings therefore agreed to the findings of Dadson (2012).

Internal Controls

Table 3 show that at least 80% of the respondents were in agreement that internal controls as a key variable in governance played a key role in enhancing the financial performance of Chase bank. It is evident from the table that all the respondents strongly agreed on the bank enhancing its internal controls to ensure a sustained financial performance. This is supported by a regression coefficient of $\beta 1 = 0.683$ (p-value = 0.000 which is less than $\alpha = 0.05$). The study therefore concluded that internal control plays an important part in improving the financial performance in Commercial banks. Mawanda (2008) conducted a research on effects of internal control systems on financial performance in institution of higher learning Uganda. In his study he investigated and sought to establish the relationship between internal control systems and financial performance in an Institution of higher learning in Uganda. The study established a significant relationship between internal control system and financial performance. This thus support the findings of this study.

Risk Management

The study also found it necessary to establish if risk management as a governance variable had a significant influence on the financial performance of Chase bank. Table 3 shows that at least 85% of the respondents were in agreement that risk management if well practiced would see the financial performance of commercial banks to improve. This is supported by a regression coefficient of $\beta 1 = 1.679$ (p-value = 0.000 which is less than $\alpha = 0.05$). Therefore, firms that consistently engage in risk management practices will always have minimal risk with robust financial performance.

We can conclude that risk management as a governance tenet improves the financial performance of Commercial banks. A Study by Oluwafemi and Obawale, (2010) on the Risk Management and Financial Performance of commercial Banks in Nigeria. The study inferred that there is a critical relationship between bank performance and risks administration. The study concluded that better risk management in such as management of funds, reducing unnecessary costs such as doubtful advances and obligation value proportion examination brings about higher financial performance. In this way, the analyst held the view that it is of high significance that commercial banks have sufficient risk administration practices which concurs with the findings of this study.

Conclusion

The objective of this study was to examine the relationship between various governance issues and Chase banks' financial performance. From the findings of the study, it was concluded that Chase bank needed to invest on governance for improved financial performance. It was evident from the results of the study that Chase bank needed to consider board characteristics, ownership, internal controls and risk management in their day-to-day running in order to record high financial performance.

From the findings, the study revealed that board characteristics, ownership, internal controls and risk management have a positive significant effect on the financial performance of Chase bank. This implies that an increase in Board characteristics, Ownership, Internal Control and Risk Management will lead to improvement in financial performance of Chase bank. In conclusion, the study strongly believes that the theoretical framework and the findings of this study will stimulate practitioners and scholars of strategy, organizational behavior and corporate governance to examine governance as a key pillar to a strong financial performance. The findings of this study have implications for all stakeholders – directors, management, regulators and shareholders.

Recommendation

From the finding the study recommends that there is need for commercial banks in Kenya to Improve their governance, as it was found that governance positively affects the financial performance of commercial banks in Kenya. The study recommends that there is need for commercial banks to increase their transparency in leadership, as it was found that this would lead to increase financial performance of commercial banks in Kenya. The study recommends that there is need for the management of Commercial banks in Kenya to increase their ownership, as it was found that to significantly affect the financial performance of commercial banks in Kenya.

The study revealed that an increase in internal controls would lead to increase in financial performance of commercial banks in Kenya. Thus the study recommends that there is need for commercial banks management to increase internal controls. The study further revealed that proper risk management improved the financial performance of the commercial banks of Kenya. The study therefore recommends implementation of risk management strategies as it was found to improve the financial performance of commercial banks in Kenya.

The study recommends firms to cultivate integrity and ethical values among its employees and management. Effective board characteristics, risk management, internal controls and risk management should be established in commercial banks in Kenya. This can be achieved by periodic performance review and evaluation of the adequacy and effectiveness of the board characteristics, ownership, internal controls and risk management designed by the internal audit department. Policies, procedures, and mechanisms should be put in place to ensure directives of the management are properly carried out in regards to strong governance.

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