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AN EMPIRICAL STUDY OF CORPORATE GOVERNANCE AND LOAN PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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Abstract

The purpose of this study was to establish the effect of corporate governance on Loan performance of commercial banks in Kenya. The study examined the corporate governance variables namely: Board Structure (BS), Audit Structure (AS) and CEO duality and their effect on Loan performance of commercial banks. Descriptive research design was used in this study and a sample representation consisting of all CEOs of the entire population of 43 commercial banks in Kenya were used as respondents. Primary data was obtained by administering questionnaires to the CEOs whereas secondary data was obtained from the published annual reports covering five years (2010-2014). Data analysis involved Karl Pearsons Correlation Coefficient and Multiple Regression Analysis and used Stata version 13 program. The study found out that BS has a positive relation while AS has a significantly negative relation on the loan performance of the commercial banks. CEO duality also on the other, shows a positive relation to the LNPLs (Linearlized Non- Performing Loans) in that the separation of the CEOs office and that of the chair leads to a decrease of the LNPLs thus resulting to better loan performance. The study also found out that corporate governance factors (BS, AS and CEO) account for 86% of the loan performance of commercial banks. The study therefore *recommended that banks should avoid overloading agenda in their committees to enhance their the quality. It further recommend for more efforts to be employed at increasing other corporate governance variables like; board expertise, policy formulation and board tenure as to improve financial performance in Kenyan banks.*

Keywords: Corporate Governance, Board Structure, Audit Structure, CEO Duality, Loan Performance, Commercial Banks, Kenya

INTRODUCTION

Like other countries, corporate governance variables in Kenya have also gained prominence (Ekadah and 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 and 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).

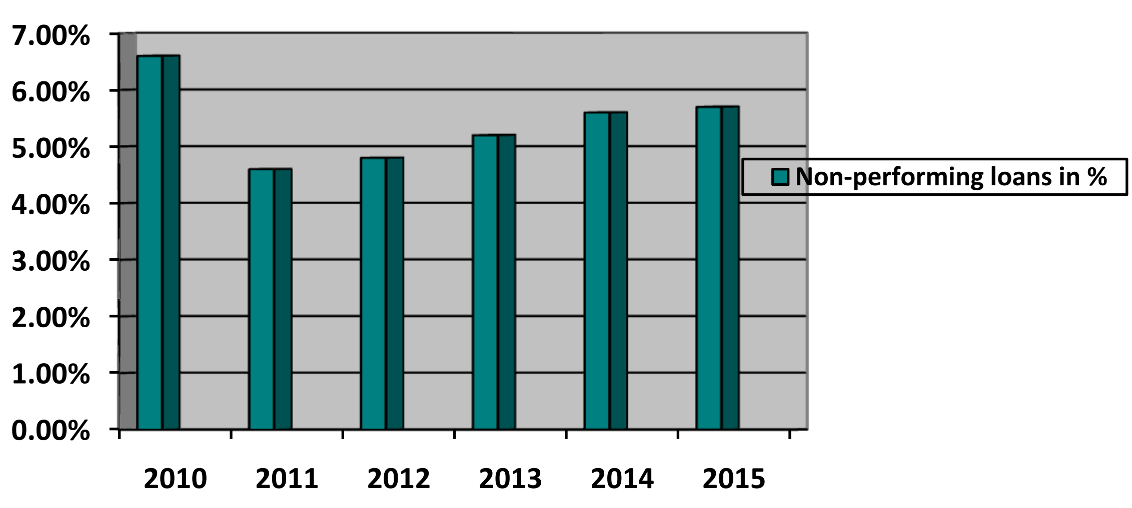
In the year 2000, the Capital markets authority took up the corporate governance frame work as a draft for all the listed companies in Kenya and it made it a must for the listed companies to put it into practice, (Wanyama, 2011). The concept of corporate governance in Kenya is now increasingly being accepted knowing that it leads to sustainable growth and more so, since Kenya has had a history of poor governance systems in the banking industry attribute to weak corporate governance practices, lack of internal controls, weaknesses in regulatory and supervisory systems, insider lending and conflict of interest which led to the collapse of many financial institution with others going under receivership (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; accountability, efficiency and effectiveness, integrity and fairness, 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).

Performance may be defined as the reflection of the way in which the resources of a company are used in the form which enables it 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 extent to which an organization achieves its intended outcome, (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.

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 shows the NPLs to total loans as per the Central bank of Kenya.

Figure 1. NPLs to total loans ratio



Source: Central bank of Kenya

From figure 1, 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 and Kusa ,2013).

PURPOSE OF THE STUDY

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

THEORETICAL REVIEW

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

Agency theory

The Agency theory was first discovered by Stephen Ross and Barry Mitnick in the year 1973. Ross was responsible for the origin of the economic theory of agency and Mitnick for the institutional theory of agency and the basic concepts that were underlying the two approaches were similar (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 and 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 personal values. (Jensen *et al.,*1976).Such conflicts of interest occurs due to difference in their preferred level of managerial effort, their attitudes towards risk and their time horizon which in turn may lead to divergence in the goals of managers and shareholders (Bozec and Bozec, 2007). This then explains on the disadvantages of the theory in that, it brings about the agency costs were some monitory 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; Managerial incentives mechanism, it compensates managerial hard work to serve the owners' interest, dividend mechanism, it reduces managerial goals to make an over investment decision which is financed by international free cash flow, 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 reduce agency cost of equity, potentially created by moral hazard manager include the interaction of owners to choose reputable 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.

Stakeholders' theory

Stakeholders' theory originated from the management discipline and gradually developed to include corporate accountability to a broad range of stakeholders. Unlike the agency theory where managers are predominantly responsible for satisfying the interest of shareholders, stakeholders theory maintains that managers in organization are not only responsible for the interests shareholders but also for a system of relationship to serve which include the suppliers, customers, employees and business partner (Abdullah and valentine, 2009).

The major debate in corporate governance focuses on whether corporate governance should focus exclusively on protecting the interest of equity holders in the corporation or should expand its focus to deal 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 key 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.

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 satisfied and motivated when organizational success is attained even at the expense of the Stewards' personal goals (Abdullah & Valentine, 2009). While the agency theory suggests that shareholder interests is to be protected by separating the posts of board chair and CEO, the stewardship theory argues that shareholder interests is to be maximized by assigning the same person to the posts of board chair and CEO to give more responsibility and autonomy to the CEO 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.

EMPIRICAL LITERATURE

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 guidelines and principles to the board of directors in order to effect their responsibilities appropriately and to satisfy shareholders. Corporate governance promotes corporate fairness, transparency and accountability and it establishes how the various participants shareholders and other stakeholders; management; board of directors cooperate in determining the direction and performance of corporations (Muriithi, 2011). The corporate governance stakeholders in the banking sector include; the board of directors, management, shareholders, Central Bank of Kenya, External auditors and the Capital Markets Authority (CCG,2004). Good governance then holds management responsible to the owners 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. and J. Mc Connell, 2002).

The performance of most of the organization is dependent on the realization of the roles of the boards (Jacob, 2011). The most commonly emphasized roles on the boards are; control and service dependence roles (Daily and strand, 1996).The control role entails directors monitoring managers as fiduciaries of stockholders, hiring and firing the executives and determining executive compensation while the service role on the other hand involves advising the executives on administrative and managerial issues (Njoka, 2010).

The idea of good governance in the banking industry empirically implies total quality management which includes the performance areas such as; capital adequacy, asset quality, management of earnings, 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).

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.

Limiting board size to a particular level is widely believed to improve the performance of the firm at all levels. Benefits arising from increased monitoring by larger boards are outweighed by poor communication and cumbersome decision-making (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 board is recommended to minimize the agency cost, by effective control over the management whereas large boards might increase a large number of 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 decreases due to a greater ability to shirk and an increase in decision making (Jensen, 1993).Boards with a large number of directors can be a disadvantage and expensive for the firms to maintain, planning, work coordination, decision-making and holding regular meetings can be difficult with a large no of board members (Wanyama and 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 and 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 the performance of the firm.

Board diligence as an important determinant of the board's effectiveness is related to factors that include the number of board meetings and its members' qualification. One view is that board meeting are beneficial to shareholders. A more diligent board concerned with devoting more time for supervision of manager's activity to achieve the shareholders' expectations (Vafeas, 1999). Moreover, when boards hold regular meetings, they are more likely to remain informed and knowledgeable about relevant performance of the company leading them to take or influence and direct the appropriate action to address the issue (Abbott, Parker and Peter 2004). Based on code of corporate governance in Nepal, boards have to sit at least twelve times per year (Poudel and Hovey 2013). Vafeas (1999), found negative relationships between board diligence and a firm's performance whereas a study conducted by

Ponnu and Karthigeyan (2010) in the Malaysian firms concluded no significant relationship between frequency of board meeting and a firm's performance.

In the agency framework, frequency of board meetings may indicate active monitoring by the board (Conger, Finegolda and Lawler, 1998). The more frequent the meetings, the increased supervision of the top management, indicating a more effective monitoring role, which might mitigate agency costs and subsequently improve firm performance. The complexity of banking business requires a more active role and effective monitoring of the board. In addition, bank board's tend be larger and have more committees, which are required to meet more frequently for effective operating purposes (Adams and Mehran, 2003).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 views on how average directors age impacts agency conflicts and, subsequently, firm performance. Senior directors have more knowledge and experience, which might facilitate effective monitoring and mitigate agency costs. On the other hand, senior directors might lack the incentive and energy to actively monitor managers, thereby intensifying agency problems (Grove *et al.* 2011). The National Association of Corporate Directors (NACD) reform acts suggested setting a retirement age and limiting the amount of time served by directors. Lehman Brothers was criticized for having 50 percent of its board members older than 70 years. Nell Minow, the editor of the Corporate Library, an independent corporate governance rating firm, gave a testimony in court which stated that the careers for a majority of Lehman's board were from a different period. In this period there was no securitization of mortgage securities, credit default swaps, derivatives trading, and in turn a lack of the systematic risk that the products created (Berman 2008). A percentage of outside directors who are over age 70 on the board is associated with weaker corporate governance and in turn higher executive compensation (Core *et al.,* 1999). Larcker *et al., (*2007) do not find evidence of an association between average director age and performance.

Having more experienced and knowledgeable directors is likely beneficial at banking firms due to their complexity. However, when the average director age exceeds a certain point, the directors might be less current with complex financial products and might lack the incentives and energy to be an effective monitor, exacerbating agency problems. Further, a board saturated with senior directors is likely to be less up to date with modern financial products such as off balance sheet derivatives (Grove *et al.,* 2011).

Board independence is very important to efficiently monitor the managers and minimize the agency cost because independent director on board have better controlling and monitoring for the opportunistic activities of the management (Poudel and Hovey, 2013). Several researchers have suggested that higher proportion of independent non-executive directors reduce the agency problems (Choe and Lee, 2003) and effective board consists of greater proportion of outside directors (Zahra and Pearce, 1989).

In the agency framework, the decision-making of non-independent directors is likely to be affected by managers, which might increase managerial entrenchment (Grove *et al.,* 2011). Concerning a majority of insiders on the board of directors, (Klein, 2002) found a lower presence of abnormal accruals when the board had more than a majority of outside directors. Another form of insider representation is large holdings of stock by executives. In the agency framework, Lasfer, (2006) finds that as managerial ownership increases, managers use their ownership power to select a board that is unlikely to monitor. Firms that exhibit high managerial ownership are less likely to have a high proportion of outsiders on the board, to separate the roles of the CEO and the chairman, and to appoint a non-executive director as a chairman. This will allow managers to promote their own interests over and above shareholder interests.

Although the executive directors have specialized skills, expertise and valuable knowledge of the firms' operating policies and day-to-day activities, there is a need for the independent directors in the board to add the fresh ideas, independence, objectivity and expertise gained from their own fields (Choe and Lee, 2003). The opaque and complex nature of banking business increases the information asymmetries at banking firms and makes it easier for insiders to exploit outside investors, and higher insider representation would worsen agency problems in banking firms (Grove *et al.,* 2011).

Some researchers like Baysinger and Butler (1985), Ezzamel and Watson (1993) and Mc Connel and Servas (1990), found outside directors are positively related with a firm's performance whereas Wen, Rwegasira, and Bilder,(2002), Brick &Chidambaram,(2008) and Loder and Martin (1997) observed negative result between outside directors and a firm's performance. Kajola, (2008) found no any significant relationship.

Audit Structure

Agency theory suggests that shareholders require protection because management (Agents) may not always act in the interest of the corporation's owners (principals). The main role of audit committee is to improve the quality of the financial reporting (Pincus, *et al.,*1989). which leads to improve the firm performance. It is likely that larger audit committee have better resources than smaller audit committee (De Zoort, *eta al.,* 2002). The decision making literature has argued that increasing the number of people involved in an activity substantially increase group performance and decrease the chance for wrongdoing because collusion becomes more difficult (Burton, *et al.,* 1977).

There is mixed result regarding audit committee size and a firm's performance. A study conducted by Klein (2002) and Coleman-Kyereboah (2007) revealed positive relationship between audit committee size and a firm's performance. However, other researchers as 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. Most people would agree, and prior research has suggested, that the independence of the audit committee is positively related to effective corporate governance oversight. Independent audit committee from management should be able to prevent management to manipulate the financial results (Beasley, 1996).The independent audit committee monitors managers better because they have no economic or personal relationship with management (Abbott *et al.,* 2004).

The empirical result on the relationship between audit committee independence and a firm's performance is ambiguous. Erickson, *et al.,* (2005), suggest the independent directors can reduce agency problem like independent audit committee. They recorded a positive relationship between audit committee independence and a firm's performance. In contrast Klein, (2002) and Weiss (2005) did not find a positive relationship between audit committee independence and a firm's performance. Coleman-Kyereboah ,(2007) examined 103 listed firms drawn from Ghana, South Africa, Nigeria and Kenya and presented no significant associations between the independence of the audit committee and with a firm's performance. Similarly, (Kajola ,2008) conducted study in Nigerian firms that shows that audit committee occupied by majority of outside members has no influence on a firm's performance.

Meeting frequency is a signal of diligence, and therefore, audit meeting frequency can be used as a proxy for diligence (Menon and Williams, 1994). Thus, for the audit committee effectiveness, member of audit committee must be willing to invest a substantial amount of time and energy in the functioning of the audit committee (Kalbers and Fogarty, 1993). Prior research by Abbott, *et al.,* (2003) suggests that an audit committee that meets frequently can improve the financial accounting processes and lead to better performance. The quality of meetings is important in that, the increase in the number of meetings doesn't necessarily enhance a firm's performance (Rebeiz and Salameh 2006). Empirical evidence by Huang *et al.,* (2008) found no relationship between audit diligence and a firm's performance.

CEO Duality

CEO duality describes a situation in which the CEO and board chair is one and the same person. This view has been called the "Stewardship Theory" (Donaldson and Davis 1991; Braun and Sharma 2007). On the other hand research also support the notion that combining the position of CEO and chair in one person may prevent the board from effectively exercising its monitoring and oversight duties (creating agency cost) and will result in lower performance (Lorsch and MacIver (1989), Millstein (1992), Coles *et al.,* (2001)).

A single person holding both the chairman and the CEO role improves the value of a firm as the agency cost between the two is eliminated (Alexander, *et al.,* 1993). On the other negative side CEO duality leads to worse performance as the board cannot remove an underperforming CEO and create an agency cost if the CEO pursues his own interest at the cost of the shareholders (White and Ingrassia, 1992). When an individual is holding two top positions there's a tendency on the path of such individual to adopt personal interests' strategies that could be detrimental to the firm as a whole (Jensen and 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).Separation of office of board chair from that of CEO generally seeks to reduce agency costs for a firm (Otieno 2012). Kajola,(2008) found a positive and statistically significant relationship between performance and separation of office of board chair and CEO. Yermack,(1996) equally found that firms are more valuable when different persons occupy the office of board chair and CEO. Large and independent boards enhance firm value and the fusion of the two offices negatively affects a firms performance as the firm has less access to debt finance (Kyereboah-coleman, 2007).

METHODOLOGY

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.

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.

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.

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.

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.

Empirical Model

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

$$\mathbf{LNPLs = \beta0+ \beta1BS + \beta2AS+ \beta4CD+ e}$$

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

AS (Audit Structure) = ACSz + ACI + ACD

e= Standard Error

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 linearlized non- performing loans (LNPLs) 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 1 shows the definition and measurement of variables.

LNPLs = β0+ β1BS + β2AS+ β4CD+ e

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

AS (Audit Structure) = ACSz + ACI + ACD

e= Standard Error

Table 1. Definition and measurement of variables

Financial performance (LNPLs)	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: Compiled by Author

EMPIRICAL FINDINGS

The major objective of this study was 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 NPLs ratio.

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 2 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 2. Descriptive Statistics of Dependent and Independent Variables

	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 N (listwise)	30				

Source: Survey Data 2016

Table 3 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 3 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 3. Regression summary for Board structure

	LNPLs2010	LNPLs2011	LNPLs2012	LNPLs2013	LNPLs2014	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

Audit Structure and loan performance

The second objective sought 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 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.

Subsequent Table 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. Study shows that audit structure in general has a significantly positive relationship of -1.825 with the LNPLs meaning that an increase in the level of the AS reduces the LNPLs 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 significancy levels reduced all through to 2014. Audit independence showed a positive relationship with the NPLs although it was not significant.

Table 4. Regression Summary for Audit Structure

	LNPLs2010	LNPLs2011	LNPLs2012	LNPLs2013	LNPLs2014	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						

CEO Duality and loan performance

The third objective sought to asses on how the CEO duality affects the loan performance of the commercial banks. Findings from table 5 shows that the CEO duality has a significantly positive relationship of 0.8192 with the LNPLs 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 5. Regression summary for the CEO Duality

	LNPLs2010	LNPLs2011	LNPLs2012	LNPLs2013	LNPLs2014	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)

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 6. Correlation matrix of Dependent and Independent Variables

		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

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.

Regression model summary

Table 7 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 it is t-value was less than 1.8.

Table 7. Regression analysis (Model summary)

	LNPLs2010	LNPLs2011	LNPLs2012	LNPLs2013	LNPLs2014	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[a]
* p<0.001						

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

CONCLUSIONS

The objective of this study was to examine the effects of corporate governance on the performance of commercial banks in Kenya by using LNPLs as the loan performance measure.. 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 LNPLs 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 LNPLs 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.

RECOMMENDATIONS

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. The study therefore recommend that banks should avoid overloading agenda in audit committees to enhance their quality in their audit structures. It further recommends for more study on other corporate governance variables like; board expertise, policy formulation and board tenure as to improve financial performance in Kenyan banks.

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