CORPORATE GOVERNANCE AND BANK PERFORMANCE: DOES OWNERSHIP MATTER? EVIDENCE FROM THE KENYAN BANKING SECTOR*

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Abstract

This paper provides an empirical analysis of banks performance in Kenya. The primary purpose of this study is to investigate the association between ownership structure characteristics and bank performance. Data utilised in the study is collected from the Financial Institutions Department of the Central Bank of Kenya, both on-site inspection reports and off-site surveillance records. Empirical results indicate that ownership structure of banks significantly influence their financial performance. In particular, board and government ownership are significantly and negatively associated with bank performance, whereas foreign ownership is strongly positively associated with bank performance, and institutional shareholders have no impact on the performance of financial institutions in Kenya. The study makes a significant contribution to financial research by extending examination of banks performance to a developing country context beyond the usual confines of the developed western economies, and adds to the small number of similar studies in the African context. The results are consistent with prior research findings, and more importantly, presents statistical justification for pursuing further corporate governance reforms with respect to banks' ownership structure to enhance the financial stability of the sector.

Keywords: corporate governance, ownership structure, Central Bank of Kenya

1. Introduction and motivation

Financial institutions as intermediaries between savers and borrowers plays pivotal role in the economic development of a country. As cited in Nada (2004), a growing body of research literature emphasis the crucial importance of the financial sector to economic growth, and analogous to the empirical evidence, The Vice President of Asian Development Bank, presenting a paper on *financial sector development and economic growth* in the wake of the Asian financial crisis states, "the better the financial sector can perform… the better the economy will perform in the long run" (Myoung-Ho, 2002, p 1).

Kenyan banking sector experienced a number of corporate failures in the late 1980s and early 1990, mainly attributed to corporate governance weakness (Central Bank of Kenya, Bank Supervision Annual Report 2001). Affirming these governance concerns, the former Governor of the Central Bank of Kenya noted, "…bad corporate governance has led to the failure of 33 banks in Kenya in 1985." (Banki Kuu News, October-December 2000, p. 4). In the absence of a vibrant market for corporate controls and relatively underdeveloped capital market, with limited number of bank listed on the stock market, it is argued that the banks' internal governance structure may impact on their performance.

This paper examines the relationship between bank performance and an important governance variable: ownership structure. Ownership is an important aspect of the internal corporate governance mechanism in that owners (shareholders) have direct influence on the board composition, a vital corporate governance mechanism.

Several reasons support the focus on Kenya. First, the banking sector plays an invaluable part in the Kenyan economy through provision of credit to key sectors of the economy, such as agriculture and manufacturing.

However, in spite of its significance, the sector has experienced a number of corporate failures, and this presents an excellent opportunity to understand the determinants of this recurring phenomenon, with particular reference to the banks' ownership structure.

Second, the Central Bank of Kenya has been continually reviewing and proposing amendments to the Banking Act principally aimed at enhancing corporate governance practices in the banking sector, especially at shareholder and board levels. However, there is no known empirical validation of the reforms pursued. In addition, given the fact that

Kenyan banking sector is characterised by various types of ownership attributes, for example, foreigners, board-dominated ownership, domestic and the government owned financial institutions, it is likely that performance will be influenced by ownership structure. Thus, the study will evaluate some of the reforms undertaken and provide an empirical justification for further reforms to strengthen corporate governance practices in the Kenyan banking sector.

Despite the banking sector's growing prominence as engine of economic development and growth, especially in the developing economies, financial researchers have paid little attention to the banking performance in the developing countries. Currently, the bulk of research on bank performance is concentrated on the developed western economies (De 2003).

Thus, this study bridges this gap, and contributes to the limited number of studies that have focused on the developing nations.

Similarly, reviewing corporate governance literature in the African context, Okeahalam and Akinboade (2003 as cited in Barako, 2004) concludes that: "there has been limited published research on corporate governance in Africa and even less rigorous academic or empirical research.

There is an urgent need to embark on a meaningful analysis of corporate governance [research] in Africa" (p.28).

These points to the general dearth of corporate governance research in the African context. Concomitant with Okeahalam and Akinboade (2003) concerns, this study empirically examines the influence of corporate governance attributes, and in particular, ownership structure on bank performance. Thus, from an African perspective, this study will add to a handful of research initiatives that have investigated relationship between corporate governance and corporate performances, by specifically focusing on an African country, Kenya.

The remainder of the paper is organised as follows. The next section overviews the Kenyan banking sector. Section 3 presents the literature review and testable hypotheses, while section 4 outlines research design and methodology.

The last section summarises findings, drawing conclusions, and policy recommendations as well as highlighting areas for future research.

2. Kenyan Banking Environment[1]

As at April 2005, the Kenyan Banking system comprise of 49 financial institutions. These include 43 commercial banks, two non-banks financial institutions, two mortgage finance companies and two building societies (Central Bank of Kenya Monthly Economic Review 2005).

Only seven (14%) of these institutions are listed on the Nairobi Stock Exchange. The Kenyan banking system is characterised by a variety of ownership structure: government, foreign, local and privately owned financial institutions.

Economic performance of the financial institutions in Kenya can aptly be described as lack-lustre, with a number of corporate failures experienced in between 1984 to 2005.

Several factors are cited as causes of bank failures: ineffective board and management malpractices, high non-performing loans, unsecured insider lending, under capitalisation and violations of Banking Act and Prudential Regulations. A cursory review of these factors depicts eminent governance failures, both at board and ownership levels.

To enhance the stability and soundness of the banking sector through improved corporate performance, the Central Bank of Kenya (CBK) initiated a number of corporate governance reforms. These reforms include: establishment of audit committees, emphasis on majority non-executive directors on bank boards, trilateral meetings between CBK, external auditors and financial institutions among others. In addition, there are proposed changes to the Banking Act with a view to defining, vetting and certifying banks significant shareholders. This is particularly essential as owners are the core of the internal governance mechanisms of any institution including those in the financial sector.

Mergers and acquisitions has been a predominant feature of the Kenyan financial sector, particularly the small and medium sized banks as way of improving efficiency, profitability and

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[1] More information on Kenyan Banking sector is contained in the Annual Reports prepared by the Financial Institutions Supervision Department of the Central Bank of Kenya covering details on the Kenyan Banking Environment, for example sector's performance, amendments to legislations, and developments in the Kenyan regulatory environment. These reports are available on the internet: site http//www.centralbank.go.ke

stability (Central Bank of Kenya, Bank Supervision Annual Report 2000).

The Kenyan Government plans to divest from certain institutions, and privatise others, while other private financial institutions have been merging as basis for enhancing capitalisation and improving earnings.

3. Literature Review and Hypotheses Development

As stated earlier, there has been paucity of research on the relationship between bank ownership and performance, especially in the developing economies. In addition, the few research studies undertaken in some developing countries depict vexing results.

Nada (2004) examines relationship between ownership structure and bank performance focussing on the Middle East and North Africa (MENA) countries. Using ownership data of 249 banks in 20 MENA countries, comprising a total of 567 observations, findings suggest that foreign banks are significantly better performers than all sample groups, while government banks performed poorly among the sampled banks.

De (2003), using panel data, investigates relationship between ownership attributes and bank performance of Indian Banks. Performance indicators utilised in the study were: return on assets, net interest margin and operating cost ratio. Results of the study suggest that there was no significant association between return on assets and ownership variables. However, when state banks are excluded from the sample, there is a significant positive relationship between return on assets and private ownership. Public sector banks are associated with higher net margins and higher operating costs.

Bonin, Hasan and Watchel (2003) study the association between bank performance and ownership structure in the context of transitional economies. Results indicate that foreign owned banks, especially those with a strategic foreign owner, are more efficient than domestic private banks. Interestingly, their findings suggest that there was no statistically significant evidence of adverse effect of government ownership to private domestic ownership.

As stated earlier, to date, empirical research on bank performance and ownership is neither consistent nor conclusive. However, agency theorists suggest that ownership structure influence corporate performance (Jensen and Meckling 1976; Fama and Jensen 1983). They argue that corporate performance is a function of the relationship between owners (principal) and managers (agents). According to Berle and Means (1932), in the context of a firm, managers as insiders have information advantage over the owners, and therefore, owners are faced

with moral hazard dilemmas, and that agents (managers) may not act in the best interest of owners. This argument explains situations within an ordinary private corporation. Banks are however, unique. Other than the owner-manager conflict of interests, in the case of a bank, there are conflict of interests between the owners (shareholders) and depositors. In line with this contention, Rafel, Miguel and vicente (2004) comments:

…there is a clear conflict inside the banks between the interests of the shareholders and the interests of the depositors, with the former being disposed to take high-risk projects that increase share value at the expense of the value of the deposits (p. 1).

Similarly, Arun and Turner (2003) drawing on the work of Macey and O'Hara (2001) who advocate for the broader concept of corporate governance, suggest that because of unique nature of banking business the corporate governance mechanisms for banks should encapsulate depositors as well as shareholders. Moreover, Browbridge (1998), reviewing causes of financial distress of local African banks noted that the moral hazard issue between depositors and owners become even more serious when a bank lend to companies associated with its directors and senior management. To specify these arguments, in the following subsections, hypotheses are advanced.

Board ownership

In the past studies observed that association between board ownership and corporate performance has been mixed. It is generally perceived that owner-managers have similar motivation as the shareholders, thus where the board members own substantial stake in an organisation, their interests are more aligned with those of the shareholders. This is consistent with the preposition of agency theorists (Jensen & Meckling, 1976), that there is positive association between managerial ownership and financial performance, because of convergence of owners and managers interests. On the contrary, Morck, Shleifer and Vishny (1998) suggest that increased managerial ownership leads to entrenchment, and engagement in non-value maximising activities.

Drawing on corporate finance and productivity literature, Palia and Lichtenberg (1999) investigate the relationship between managerial ownership and firm performance. Using a sample of 255 manufacturing firms in the period 1982 to 1993, they provide evidence of a positive relationship between managerial ownership and productivity. Similarly, Kim (2002), employing Japanese data for 1993 and 1996, generate empirical evidence of managerial ownership as a viable substitute for the traditional *keiretsu* and bank shareholding. In fact, he argues

that manager-owned firms display better controls than other firms in which *keiretsu* and banks are major shareholders.

However, banks are different from other organisations, and with increase in board ownership stake there may be greater conflict of interests with the depositors. In this regard, Pinteris (2002) document a negative relationship between bank ownership concentration and bank performance in the Argentinean banking industry. He reports that banks with a more concentrated ownership structure exhibit higher loan-portfolio risk. He explains the finding as an illustration of ownership concentration exacerbating agency conflicts, specifically between bank owners and bank depositors. Similarly, Fogelberg and Griffith (2000) examine the relationship between managerial ownership and firm performance for a sample of commercial bank holding companies, and found that managerial entrenchment influence bank performance. In addition, Hirschey (1999) reports an inverse relationship between managerial stock ownership and commercial banks performance; measured as accounting profits and market values. In line with the above discussion, the following hypothesis is examined:

ROA ratio - Hypothesis 1a:The higher the level of a firm's board ownership, the lower the profit.

NPL ratio - Hypothesis 1b:The higher the level of a firm's board ownership, the higher the level of Non-Performing Loan.

Foreign Ownership

Evidence of foreign ownership on bank performance is inconsistent. A number of studies cited by Nada 2004 (for example, DeYoung & Nolle, 1996; Hasan & Hunter 1996; Mahajan et al., 1996; Chang et al., 1998) indicate that foreign owned banks are less efficient than the domestic banks. However, these studies have solely focused on developed economies. In contrast, studies that examined bank performance in the developing countries context (for example, Claessens, et al., 2000; Demirguc-Kunt & Huizinga, 1999) suggest that foreign owned banks report significantly higher net interest margins and higher net profitability than domestic banks.

There may be various reasons for better performance of foreign owned banks. These include, but not limited to, prudent management of risks as influenced by the policies of the parent company, and strict focus on profitability to maximise shareholders wealth creation capacity. In contrast, domestic banks may suffer from inefficiencies, external interference and possibly not always focused on maximising returns, thus affecting their earnings and capacity to grow. According to Demirguc-Kunt and Detragiache (1998) the benefits of foreign banks into a country's financial system

include improved efficiency and enhanced competition. Hence, the local financial institutions are forced to upgrade their banking practices and operations to match industry benchmarks heavily influenced by the foreign banks. Allen, Clarke, Cull, Klapper and Udell (2004), suggest that foreign banks have superior ability to diversify risks and may provide certain services to multinational clients that domestic banks may not easily offer.

In view of the foregoing discussion, the following hypothesis is examined: *ROA ratio - Hypothesis 2a: The higher the proportion of a firm's foreign ownership, the higher the profit.*
NPL ratio - Hypothesis 2b:The higher the proportion of a firm's foreign ownership, the lower the level of Non-Performing Loan.

Institutional Ownership

In finance literature, it is generally perceived and argued that institutional shareholders have greater incentives to monitor corporate performance, than diffused smaller shareholders. Institutional shareholders help resolve 'free-ride' problem commonly associated with corporations where shares are widely held. However, the empirical results present mixed findings.

Agrawal and Mandelker (1990) investigate the role of large shareholders in monitoring managers when they propose anti-takeover-charter amendments. They used a sample of 372 firms that proposed anti-takeover amendments during 1979 to 1985. They find that there is a statistically significant positive relationship between institutional ownership and the shareholder-wealth effect of various types of amendments. This result is consistent with institutional shareholders' oversight of managerial decision-making, especially when shareholders' wealth is affected.

Using data for 51 firms targeted by the California Public Employees' Retirement System (CalPRES) from 1987 to 1993, Smith (1996) investigate the monitoring role of institutional shareholders and its effect on firms' governance structure, shareholder wealth and operating profit. The overall results indicate that institutional-shareholder activism causes changes in governance structure, which also results in a significant increase in shareholders' wealth.

On the contrary, and from an empirical perspective, Faccio and Lasfer (2000) refute the governance role of an institutional shareholder when they analysed the monitoring role of occupational pension funds in the UK, by comparing firms in which these funds hold a large stake and a control group with similar size and industry attributes. Their results suggest that pension funds do not add value to firms in which they hold a higher stake. The findings cast serious doubts on the monitoring role of pension

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funds, leading to their conclusion that pension funds are ineffective monitors. Probably, it matters the policies (active or passive) of the institutional owners. Thus based on the above, the following hypothesis is examined: *ROA ratio - Hypothesis 3a: The presence of a firm's institutional ownership is positively associated with profit.*

NPL ratio - Hypothesis 3b: The presence of a firm's institutional ownership is negatively associated with the level of Non-Performing Loan.

Government Ownership

La Porta, Lopez-de-Silanes and Shleifer (2002) documents two theoretical perspectives for government ownership of banks: *development and political.* The development theorists argue that government ownership of banks facilitates allocation of credit to strategic and long-term socially desirable project that otherwise may not get private funding. The political theorists suggests that government own banks to fund inefficient but politically desirable projects.

While these arguments may have some merits, recent research study by Barth, Caprio and Levine (2000) indicates that government ownership of banks strongly correlates with banks inefficiency and lower productivity. Similarly, Cornett, Guo, Khaksari and Tehranian (2000) conduct a cross-country analysis, involving five Asian countries, namely, Thailand, Indonesia, Philippines, South Korea and Malaysia. Their findings suggest that government ownership is associated with poor performance. Similarly, Allen et al., (2004), using 1990s data from Argentina examine association between corporate governance and bank performance, and conclude: "…our strongest and most robust results concern state ownership. State-owned banks have poor long-term performance…" In addition, as cited in Nada (2004) private ownership of banks is strongly associated with superior financial performance (Lang & So, 2002 Cornett et al., 2000). Moreover, government ownership of banks creates an avenue for promoting and propagating political patronage that adversely affect performance of these institutions. Based on the above discussion the following hypotheses are advanced.

ROA ratio - Hypothesis 4a: There is negative relationship between a firm's government ownership and bank profitability performance.

NPL ratio - Hypothesis 4b: There is positive relationship between a firm's government ownership and bank performance measured as non-performing loans.

Control Variable

Yoshikawa (2003) examine the relationship between ownership and performance of Japanese corporation,

and control for firm size, suggesting that size accounts for scale and scope of an institutional operation. Corporate size may confound relationships between ownership structure and bank performance (Chen and Metcalf, 1980). Size may portray the ability to provide a range of banking services, and therefore, a large client base that boost institutional financial performance. Larger firms may also have better expertise in terms of human resource (intellectual capital), hence capacity to manage risks better than smaller financial institutions.

Based on the foregoing discussion, bank size as measured by percentage of a firm's deposit to sector's total deposit is included in the empirical model as a control variable.

4. Research design and Methodology

4.1. Sample

The sample of this study comprise all financial institutions operating in Kenya as contained in the Directory of banks and non-bank financial institutions of the Financial Institutions Department of the Central Bank of Kenya. The main criteria used for inclusion of a financial institution are: (i) Bank must be in operation for the entire study period, year 2000 to year 2004. Banks that collapsed or exit the industry during this period are excluded from the sample. (ii) All relevant information on ownership and performance must be available. Table 2 presents a list of financial institutions included in the study [See appendices Table 2].

4.2. Variables Measurement

Below is a discussion of the main categories of variables examined in the study and details on their measurement. Table 1 presents a summary of the variables definitions and measurements.

4.2.1. Dependent variable (ROA and NPL - Performance indicators)

The performance measures utilised in this study are: ratio of non-performing loans (NPL) to total advances and Return on Assets (ROA). The reasons for using these performance parameters are that return on asset is the most common performance indicator used in prior research studies (Claessens at al., 2000; and Mahajan et al. 1996), and the level non-performing loans remains one of the most fundamental issue affecting the stability of the Kenyan financial system (Central Bank of Kenya, Bank Supervision Annual Report 2001). The quality of this measure is further affirmed by the fact that non-performing loan assessment and monitoring is core to both on-site examination and off-site surveillance by the Financial Institutions Supervision

Department of the Central Bank of Kenya in ensuring soundness and stability of financial institutions. Moreover, the NPL ratio used in this study is the adjusted value after taking into account additional provisions recommended by the central bank examiners.

4.2.2. Independent variables

The overarching independent variable in this study is the corporate governance mechanism being investigated: ownership structure. The main categories of ownership variables studied are: level (concentration) of board ownership, proportion of foreign ownership, institutional ownership and percentage of government ownership.

The board ownership variable is measured as the proportion of board shareholding to total value of shares of a financial institution. This information is extracted from appendices in the inspection reports and other institutional records available in the Financial Institutions Supervision Department.
Foreign owned banks are defined as financial institutions in which foreigners (non-Kenyans), whether, corporation or individuals own majority shareholdings. These include multinational subsidiaries of foreign banks and banks owned by other foreign organisations.

A financial institution is defined as owned by an institutional shareholder when a clearly identifiable corporate body owns more than 30% of the shareholding of its total share value, while government-owned financial institutions refer to those institutions in which the Kenya government has shares. This is identified as, where the government interest is specified in shareholding in the institution and or when government representatives, for example, permanent secretary sits on the board of the financial institution.

4.3. Multivariate Model

An Ordinary Least Square (OLS) model was applied as a multivariate test to assess the influence of each of the independent variable on performance. The test is based on the following statistical model:
$$PERF_{it} = \beta_0 + \beta_1 BODOWN + \beta_2 FOROWN + \beta_3 GOVOWN + \beta_4 INSOWN + \beta_5 SIZE + e_i$$

Where:
$PERF_{it}$ = Performance (measured as ratio of Return on Assets and ratio of Non-Performing Loan) of bank i at time t.

BODOWN = Proportion of board ownership to total shareholding.

FOROWN= Ratio of foreign ownership stake to total shareholding.

GOVOWN= Dummy variable, coded 1, for a financial institution in which Kenya government hold ownership, and 0 for institutions in which the Kenya government has no ownership.

INSOWN= Dummy variable, coded 1, for a financial institution in which there is (are) identifiable institutional shareholders other

than the Kenya Government 1, and 0 for financial institutions with no institutional shareholders.
SIZE = Proportion of an institution's deposit to the total of banking sector deposit.

e_i= Residual term.

5. Results

5.1. Descriptive statistics

Table 2 (Panel A and B) presents summary of the two performance indicators, (dependent variables) in the regression model. Overall, there appears to be improvement in the level of performance in the recent years based on the mean of the two performance parameters, especially the mean of non-performing loan dropped from a high of 32% in year 2000 to 20% in year 2004. However, the standard deviation suggests that there are great disparities in the performance of the financial institutions in Kenya.

Table 3 shows bivariate correlation between the dependent variable, independent variables and control variable. The Pearson correlation shows a significant association between bank performances, measured as Return on asset and board ownership and foreign ownership variables. These results provide initial support *Hypothesis 1* and *Hypothesis 2* respectively. Similarly, there is a significant correlation between ratio of non-performing loan as performance indicator and foreign and government ownership of financial institutions.

Table 3 results also indicate significant correlation between the independent variables and the control variable. The highest value is between board ownership and foreign ownership (Pearson correlation = -0.49). Gujarati (1988) and Hair, Anderson, Tatham and Black (1995) suggest that correlation between the independent variables is considered undesirable for multivariate analysis if the value exceeds 0.8. A more rigorous and diagnostic method widely used is the *Variance Inflation Factor* (VIF)[2] for each of the independent variable. VIF values are contained in the last column of Table 4 and Table 5. The VIF values for all the independent variables are below 2 far less than 10 considered harmful for a regression analysis (Netter, Wsserman & Kutner, 1989). Thus, the correlation matrix and VIF values suggest that multicollinearity is not a serious issue.

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[2] Madalla (1992) explained VIF as follows: $VIF(\beta_i) = 1/[1-R_i^2]$ where: R_i^2 is the squared multiple correlation coefficient between x_i and other explanatory variables and $VIF(\beta_i)$ is the ratio of the actual variance of (β_i) to what the variance of (β_i) would have been if x_i were to be uncorrelated with the remaining x's.

5.2. Empirical Results

The results of multivariate tests of the hypotheses developed are documented in Table 4 and 5. In conducting the test, both pooled cross-section and time series data is used. To accommodate the panel data, year dummies are included in each of the regression equations. As stated earlier, the dependent variables in the regression model are performance parameters measured as Return on Assets (ROA) and proportion of Non-performing loans to total loans.

5.2. Dependent variable: Return on Assets (ROA)

Using the overall performance parameter of ROA, the proportion of board ownership is strongly and negatively associated with bank performance. It is the most important predictor of an institution's financial performance, with highest standardised coefficient of -0.282 significant at less than the 0.01 level. The finding is consistent with the hypothesised negative relationship between board ownership and bank performance.

Consistent with the hypothesised relationship, government ownership of banks is significantly negatively associated with banks' financial performance. This result is consistent with findings by Barth et al. (2000) and Cornett et al. (2000), all of who associate government ownership of banks with poor financial performance.

Although it had the expected positive sign, the foreign ownership variable is not significantly associated with bank performance. Surprisingly, contrary to hypothesised positive relationship, though not significant, the coefficient of the institutional owner variable has negative sign, suggesting that institutional shareholders have negative influence on bank performance. Therefore, Hypotheses H1a and H4a are accepted and H2a and H3a are rejected.

5.3. Dependent variable: Non-Performing Loans

Three hypotheses: H2b, H3b and H4b are significant predictors of the level of NPL. Proportion of foreign ownership is strongly and negatively associated with bank performance measured as ratio of non-performing loan to total loan. Foreign ownership variable is the most significant predictor of an institution's level of non-performing loans. The result indicates that foreign ownership of banks have significant influence on bank performance, possibly through better management of credit risks, thus lowering the level of non-performing loans and improving earnings and profitability. This result supports hypothesis 2, and is consistent with prior

research findings by Claessens, et al., 2000; Demirguc-Kunt & Huizinga, 1999.

Government ownership of banks is significantly positively associated with higher level of non-performing loans as a proportion of bank loans. The finding therefore, suggests that unlike foreign ownership, state-ownership of banks impact negatively on bank performance due to high levels of non-performing loans associated with this type of ownership structure. This result is consistent with findings of Cornett et al. (2000) and Allen et al. (2004) who report that state- owned financial institutions perform poorly for the sample of five Asian countries and Argentina banks examined.

Surprisingly, like government owned financial institutions, institutional ownership of financial institutions are positively related to the level of non-performing loans as proportion of the total loan. Thus, institutional ownership of banks impacts negatively on their financial performance. The finding is inconsistent with the hypothesised negative relationship with the proportion of non-performing loans.

Board ownership has the expected positive sign however the variable has no significant influence on the level of non-performing loans. Therefore, H1b is rejected. This implies that with respect to bank financial performance; measure as ratio of non-performing loan to total loan, other ownership structure such as, the level of foreign ownership, government or institutional owners are better predictors.

5.4. Robustness Check

To ensure robustness of the results, multiple approaches are helpful and recommended (Cooke, 1998). As a robustness measure, a rank regression analysis was performed. As cited in Ho and Mathews (2002), Wales, Naser and Mora (1994) and Hopwood and McKeown suggest that rank transformation provides additional confidence in statistical results because it: (i) yields a distribution free data; (ii) provides results similar to those that can be derived fom ordinal transformation and (iii) mitigates the impact of measurement error, outliers and residual heteroscedasticity on the regression results.

Although not reported here, rank regression analysis also support the findings based on the regression model specified above, the proposition that banks ownership characteristics influence financial institutions performance. As discussed in the preceding section, rank regression analysis, indicates that board and government ownership a significantly negatively associated with bank performance

6. Conclusions and Policy Recommendations

The purpose of this research is to empirically examine relationship between ownership structure and bank performance in the Kenyan context. Ownership structures investigated include: proportion of board ownership, level of foreign ownership, institutional and government ownership. Performance parameters utilised in the study are Return on Assets and proportion of non-performing loans to total loans.

The results of the OLS regression provide strong support for the proposition that ownership structure influence bank performance. Level of board ownership, proportion of foreign ownership and government ownership are associated with performance of financial institutions in Kenya. While the findings provide credence to prior research findings, they are of particular relevance for policy makers and regulators in Kenya. In this regard, irrespective of the performance measures used: Return on Assets or ratio of non-performing loan, this study present a compelling and strong evidence of negative relationship between state ownership and bank performance.

For the past few years, the Kenyan government has been in the process of restructuring and privatising state owned financial institutions. In light of the empirical finding, this is a right initiative. To further augment this measure and to enhance stability of the financial sector, the government should speed up restructuring and privatisation of these institutions. The advantages of speedy finalisation of these restructuring processes are; a substantial reduction in the level of non-performing loan of the Banking Sector. In this respect, the Central Bank reports:

While the banking sector is characterised by high levels of non-performing loans at Kshs. 71.3 billion, a high proportion of these NPLs at Ksh 43 billion or 59.8% of total NPLs are concentrated in five public sector institutions. The ongoing restructuring of these institutions will address the problem of high non-performing loans in the banking sector (Monthly Economic Review, April 2005, p.32).

Thus, the government divestiture program would enhance stability of the banking sector by impacting positively on the sector's level of non-performing loans, and save the Kenya government costs associated with subsidising operations of some of these institutions, such as capital requirements to be compliant with the Banking Act and Prudential Regulations.

The proportion of board ownership of a financial institution is significantly and negatively associated with an institution's performance, measured as return on assets. This implies that board ownership of a bank impacts negatively on financial performance of an institution. The finding of the study is consistent with the entrenchment hypothesis, that board ownership of financial of institutions exacerbates the conflicts of interests between owners and depositors. Specifically, board ownership depicts a clear picture of conflicts of interests between owners and depositors, and probably the risk-taking tendencies of such institutions. This empirical finding lends credence to the theoretical assertions by Brownbridge (1998), which states:

"In many of the failed banks, majority of the shares were held by one man or one family, while managers lacked sufficient independence from interferences by owners in operational decisions." (p. 180).

As a regulator, this is of particular concern to the Central Bank of Kenya. Given the strong negative correlation between level of board ownership of a bank and bank performance, the Central Bank of Kenya should: (i) Review the relevant part of the Banking Act to decisively address such ownership structure that may pose a significant risk to the financial stability of the Banking sector in Kenya, and (ii) From a supervisory perspective also, consider ownership as integral to risks assessment, both to an institution's performance and stability of the sector. Thus, as part of the supervisory process, institutions should be classified into various risk categories based on ownership structure. In particular financial institutions in which board members and government hold ownership stake pose major regulatory challenges and risks.

In line with this finding, it is important to note that proposed amendment to the Banking Act in 2004, with respect to vetting and certification of significant shareholder of a financial institution is a step in the right direction. However, given this ubiquitous culture of circumventing the law, with the hindsight of the regulatory knowledge, it may be prudent for the Central Bank to vet and certify all shareholders for specific financial institutions. This is important because it is likely that a purportedly 'minority shareholder' may impact significantly on the operations of a financial institution. The minority share ownership may just be a deliberately orchestrated attempt at circumventing the law.

In addition, given the fact that the board ownership variable is the most significant predictor of a bank performance measured as return on asset, subject to corroboration of this finding through similar qualitative and quantitative studies, the Central Bank, may have to consider having nominees on the board of certain financial institutions. The nominee is expected to engage board discussions and deliberations with the sole responsibility of preserving public interests: depositors.

Surprisingly, using both parameters of performance indicators, results consistently indicate that institutional shareholders have no significant influence on financial performance of banks. This implies that unlike western economies where institutional shareholders have been agents of change, especially promoting sound corporate governance practices, in Kenya, institutional shareholders are inactive. This requires a comprehensive sensitisation program for this type of bank owners to actively participate in strategic direction of their respective institutions. Through their shareholding, the institutional shareholders may influence board composition, thus impacting on a banks performance by co-opting competent personalities to the board. Certainly, active participation of institutional shareholders in bank affairs in the long run will improve corporate governance in the banking sector, and minimise the 'free-rider' problem associated with individual shareholder.

The OLS regression results also, providence a strong evidence of a significant positive relationship between the proportion of foreign ownership and bank performance. This is consistent with the hypothesis and previous research findings, for example Claessens at al. (2000) and Demirguc-Kunt and Huizinga (1999). It is likely that foreign owned banks are influenced by policies and procedures by the parent company, which may provide a better basis for evaluating and mitigating risks. However, the more important implication of this particular finding is that local banks can do just as well with improved corporate governance and better assessment and management of business risks. The finding only portends challenge to the local bank owners to manage banking business risks prudently to be profitable and competitive.

Finally, given the overall significant influence of ownership attributes on financial performance of financial institutions, it may be time to consider issuing comprehensive guidelines on ownership and corporate governance in the banking sector. The guidelines should among other issues, specify the minimum corporate governance practices required of a financial institution, and emphasise diversification of ownership, as well as disclosure of the ultimate beneficiaries of the shareholding of the financial institutions in view of the public interest at stake. In particular, the corporate governance guideline should clearly distinguish between ownership and management to ameliorate the imminent conflict of interests.

The finding of this study presents a number of avenues for future research. For instance, replicating this study in other regulatory regimes, for example within the eastern Africa, may enhance the understanding of the relationship between corporate governance and bank performances within the region, thus formulating corporate governance policies based on empirical findings. Similarly, applying this approach to other regulated industries may enhance generalisability of the findings across sectors. Another potential area for research is the interrelationship between various governance mechanisms, for example ownership structure and board characteristics, as argued and empirically examined by Belkhir (2005).

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Appendices

Table 1. Operational definitions of variables

Variables	Definition	Source of information
Performance (ROA)	Return on Assets measured as profit before tax to total assets.	Bank Supervision Annual Reports
Performance (NPL)	Ratio of non-performing loans to total assets	Bank Supervision Annual Reports
Independent Variables		
Board Ownership	Ratio of board share to total value of shares of an institution.	Off-site surveillance data
Foreign ownership	Financial institution in which foreigners have more than 50% of ownership stake.	Off-site surveillance data
Institutional owners	Institutional in which a corporate body has more than 30% of total share value.	Off-site surveillance data
Government ownership	Financial institutions in which government have interest directly or through Stated Owned Corporations.	Off-site surveillance data
Control variable		
Bank Size	Market share of deposit defined as ratio of an institutions deposit as 31st December of a given year to total deposits of the Banking sector for the same period.	Bank Supervision Annual Reports

Table 2. Performance descriptive statistics: Return on Assets* and Non-Performing Loan Ratio

	Maximum	Minimum		Mean		Std. Dev.
Panel A:						
Overall RoA	36.54	-16.70		1.25		4.03
By Year						
2000	5.21	-13.94		0.52		3.81
2001	8.00	-13.91		1.07		3.35
2002	5.00	-6.60		1.24		2.23
2003	6.41	-16.70		1.48		3.70
2004		-16.55		1.25		4.03
By ownership						
Board		-16.70		1.06		4.83
Foreign	5.98	-4.04		2.34		1.85
Institutional	6.05	-7.62		1.41		2.58
Government	4.78	-4.84		0.43		2.32
Panel B						
Overall NPL ratio	91.60	0.00		24.66		18.78
By Year						
2000	70.40	0.80		32.25		18.60
2001	76.00	0.00		24.72		18.35
2002	91.6	0.10		23.84		18.99
2003	76.80	0.20		22.73		18.57
2004	83.20	1.40		19.75		17.87
By ownership						
Board	91.60	0.00		23.90		18.78
Foreign	5.98	-4.04		2.34		1.85
Institutional	70.10	1.40		26.22		20.07
Government	75.55	7.80		39.01		19.13

* For purpose of computing descriptive statistics, all ownership variables are binary coded, that is, 1 for a particular ownership type, and o otherwise.

Table 3. Pearson Correlation

VARIABLES	1	2	3	4	5	6	7
(1) ROA	1.000						
(2)NPLratio	-0.446**	1.000					
(3) BOWN	-0.229**	0.079	1.000				
(4) FOROWN	0.148*	-0.281**	-0.49**	1.000			
(5) INSTOWN	0.049	-0.043	-0.247**	0.207**	1.000		
(6) GOVOWN	-0.081	0.226**	-0.328**	0.014	0.197**	1.000	
(7)MSHARE	0.100	-0.049	-0.320**	0.237**	0.249**	0.186**	1.000

Table4. Pooled regression estimates: 2000-2004
(Dependent variable: Ratio - Return on Assets)

Independent Variables	Predicted sign	Standardised Coefficient	t- statistics	P-value	VIF Values
Test Variables					
Board ownership	-	-0.282	-3.311	0.001*	1.689
Foreign Ownership	+	0.006	0.075	0.941	1.386
Institutional Ownership	+	-0.039	-0.564	0.574	1.089
Government Ownership	-	-0.182	-2.547	0.012*	1.186
Control Variable					
Size – market share	+	0.038	0.532	0.595	1.169
2001		0.054	0.654	0.514	1.600
2002		0.076	0.914	0.362	1.601
2003		0.099	1.198	0.232	1.601
2004		0.141	1.697	0.091	1.600
R-square	9.7%				
Adjusted R-square	5.8%				
F-value	2.49				
Sig. F	0.010				

* Significant at less than 1% confidence level.

Table 5. Pooled regression estimates: 2000-2004
(Dependent variable: Ratio – Non-Performing Loans)

Independent Variables	Predicted sign	Standardised Coefficient	t- statistics	P-value	VIF values
Test Variables					
Board ownership	-	0.111	1.437	0.152	1.689
Foreign Ownership	+	-0.263	-3.782	0.000*	1.386
Institutional Ownership	+	0.301	4.883	0.000*	1.089
Government Ownership	-	0.274	4.254	0.000*	1.186
Control Variable					
Size – market share	+	0.028	0.442	0.659	1.169
2001		-0.162	-2.159	0.032	1.600
2002		-0.182	-2.431	0.016	1.601
2003		-0.206	-2.750	0.006*	1.601
2004		-0.268	-3.583	0.000*	1.600
R-square	26.7%				
Adjusted R-square	23.4%				
F-value	8.418				
Sig. F	0.000				

* Significant at less than 1% confidence level.

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