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CORPORATE GOVERNANCE AND BANKING SECTOR IN KENYA

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Abstract

This paper examines corporate governance and banking sector in Kenya. Banks play an important role in the economy of a country. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates economic activities. Thus, weak governance in the banking sector can have far reaching consequences to the economy of a country. The paper outlines the theoretical framework underpinning corporate governance then reviews the major corporate governance concepts in general. The paper goes ahead to examine the Kenyan banking sector in terms of the structure and the regulatory framework. Further, the paper puts into perspective the corporate governance framework in Kenya narrowing down to the corporate governance guidelines in the banking sector. Lastly, the paper assesses the effectiveness of these guidelines and draws vital lessons in the conclusion.

Keywords: Corporate governance, Banking sector, Prudential guidelines, Transparency, Central Bank of Kenya

INTRODUCTION

Corporate Governance involves the manner in which the business and affairs of an institution are governed by its board and senior management and provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. The purpose of corporate governance is to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity thereby supporting stronger growth and more inclusive societies. The objective of corporate governance is to realize shareholders' long-term value, while taking into account the interests of other stakeholders (Ehikioya, 2009).

The demand for good corporate governance is growing in emerging market countries in order to help companies and financial institutions improve their performance, access affordable external financing, and lower the cost of capital with the broader goals of advancing financial stability and economic growth. Banks play an important role in the economy of a country. When banks efficiently mobilize and allocate funds, it lowers the cost of capital to firms, boosts capital formation and stimulates productivity.

In the recent past the banking sector in Kenya has witnessed a number corporate governance issues. The closure of three banks in a spate of nine months (Dubai Bank in August 2015, Imperial Bank in October 2015 and Chase Bank in April 2016) has sent jitters among millions of bank customers resulting into confidence crisis. This is attributed to failure by banks to adhere to disclosure requirements spelled out in the prudential guidelines issued by the Central Bank of Kenya (CBK). This paper reviews corporate governance framework in the banking sector in Kenya.

THEORITICAL FRAMEWORK

There are, at least four theories of corporate governance (Pandey, 2011). These theories are as follows:

The Agency Theory

The pure finance view of the firm is that managers must maximize the shareholders' wealth. The shareholder wealth maximization may not work because of the agency problem. The basis for the agency theory is the separation of ownership and control. The principals (shareholders) own the company, but the agents (managers) control it. The discretionary powers possessed by the managers motivate them to expropriate the company's wealth to themselves. Thus they may not work to maximize the owners' value.

Under the agency theory of corporate governance, the main concern is to develop rules and incentives, based on implicit or explicit contracts, to eliminate or at least, minimize the conflict of interest between owners and managers. The firm devises rules and incentives of its own which may be in addition to legal regulations in a country.

The Stewardship Theory

This theory views managers as stewards. They are assumed to work efficiently and honestly in the interests of company and owners. They are self-directed and are motivated by high achievements and responsibility in discharging their duties. In this theory, managers are goal-oriented and self-motivated and feel constrained if they are controlled by outside directors.

The Stakeholder Theory

The stakeholder theory is based on the premise that the fundamental responsibility of managers is to maximize the total wealth of all stakeholders of the firm, rather than only the shareholders' wealth. Hence, the corporate governance efforts are intended to empower those stakeholders who contribute or control critical resources and skills and to ensure that the interests of these stakeholders are aligned with that of shareholders.

The Political Theory

The political theory states that it is the government that decides the allocation of control, rights, responsibility, profit et cetra between owners, managers, employees and other stakeholders. Within the overall macro-structure, each stakeholder may try to enhance its bargaining power to negotiate higher allocation in its favour. The corporate governance efforts will, thus, depend on the allocated powers of the stakeholders.

CONCEPT OF CORPORATE GOVERNACE

The Private Sector Corporate Governance Trust (PSCGT), which is the heart of the corporate governance initiative in Kenya, is private-sector-led. It is an initiative to improve the quality of life in Kenya and the African region by fostering the highest standards of corporate governance in all organizations. In this endeavour, it has adopted an all inclusive approach, which demands that all stakeholders, including government, corporations, value-led organizations and society as a whole, effectively play their role.

PSCGT (1999) views corporate governance, as the manner in which the power of the corporation is exercised in the stewardship of the corporation total portfolio of assets and resources with the objective of maintaining and increasing shareholders value through the context of its corporate vision.

The Cadbury Committee Report (1992) defines corporate governance as the system by which companies are directed and controlled. According to this report, good corporate governance must encompass four key aspects. Firstly, establishing a board of directors that has clear responsibilities and whose role of directing or governing is different from that of the firm's managers. Secondly, establishing checks and balances in governance structures with no one person having unfettered power. Thirdly, having a well balanced board team composed of executive and non executive directors and lastly Ensuring transparency of a board in directing and controlling an organisation.

The Capital Market Authority (CMA) in Kenya, in year 2000 defined corporate governance as the process and structures used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value while taking into account the interests of other stakeholders.

According to the corporate governance guideline issued by CMA (2002), the objective of these guidelines is to strengthen corporate governance practices by public listed companies in Kenya and to promote the standards of self-regulation so as to bring the level of governance in line with international trends.

According to Kenya Banking Act (2013), Corporate Governance involves the manner in which the business and affairs of an institution are governed by its board and senior management and provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the institution and its shareholders, facilitate effective monitoring and define how an institution:

a) sets corporate objectives, including generating economic returns to owners;

b) runs the day-to-day operations of the business;

c) considers the interests of recognized stakeholders; aligns corporate activities and behaviors with the expectation that the institution will operate in a safe and sound manner, and in compliance with applicable laws and regulations;

d) And protects the interests of depositors.

According to Organization for Economic Co-operation and Development, (OECD 2015) Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. The purpose of corporate governance is to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

OECD has developed principles of corporate governance intended to help policymakers evaluate and improve the legal, regulatory, and institutional framework for corporate governance, with a view to support economic efficiency, sustainable growth and financial stability. This is primarily achieved by providing shareholders, board members and executives as well as financial intermediaries and service providers with the right incentives to perform their roles within a framework of checks and balances. The *Principles* are: I) Ensuring the basis for an effective corporate governance framework; II) The rights and equitable treatment of shareholders and key ownership functions; III) Institutional investors, stock markets, and other intermediaries; IV) The role of stakeholders; V) Disclosure and transparency; and VI) The responsibilities of the board.

According to Philippe H. (2010), corporate governance encompasses rules, regulations and practices by which managers and owners are held accountable and responsible for whatever performance society expects. For example the rules and regulations that govern banks as lenders and as investors, clarifying rights and responsibilities of investors as shareowners. Ultimately, however, the main instrument of corporate governance remains the role and responsibility of the Corporate Board.

Rehman and Mangla (2010) state that effective corporate governance mobilizes the capital annexed with the promotion of efficient use of resources both within the company and the larger economy. It also assists in attracting lower cost investment capital by improving domestic as well as international investor's confidence. Good corporate governance ensures the accountability of the management and the Board. The Board of directors will also ensure legal compliance and take impartial decisions for the betterment of the business. It is understood that efficient corporate governance will make it difficult for corrupt practices to develop and take root, though it may not eradicate them immediately.

Levine (2004) observes that Banks have two related characteristics that inspire a separate analysis of the corporate governance of banks. First, banks are generally more opaque than nonfinancial firms. Although information asymmetries plague all sectors, evidence suggests that these informational asymmetries are larger with banks. Second, banks are frequently very heavily regulated. Because of the importance of banks in the economy, because of the opacity of bank assets and activities, and because banks are a ready source of fiscal revenue, governments impose an elaborate array of regulations on banks. At the extreme, governments own banks.

Literature has identified two broad models of corporate governance: the shareholder and the stakeholder models (Reed, 2002; Allen, 2005; West, 2006). According to Allen (2005), the shareholder model holds the view that the firm is run in the interest of the shareholders. This model is mainly based on agency theory, which holds that managers will not act to maximize the returns to shareholders unless appropriate governance structures are implemented in the large corporation to safeguard the interests of shareholders (Jensen and Meckling,1976; Fama and

Jensen, 1983). It continues to argue that the owners are principals and the managers are agents and there is an agency loss, which is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners, exercised direct control of the corporation (Jensen and Meckling, 1976). On the other hand, the stakeholder model focus on ensuring that the organization resources are used efficiently for the benefit of all those that may influence or are influenced by the corporation (Allen, 2005; West, 2006). Allen (2005) argues that the shareholder model of corporate governance is more appropriate in the Anglo-Saxon countries such as the USA and the UK, since their markets are perfect and complete. However, most developing markets are both imperfect and incomplete, making the stakeholder model more appealing in developing countries. Prior studies have shown that most commonwealth developing countries (including Kenya) have adopted a modified shareholder approach to corporate governance (West, 2006)

The failure of high profile companies in the USA, UK and other parts of the world has largely been attributed to failures in the corporate reporting process (IFAC, 2003).In the USA, the failure of the Enron Corporation in late 2001, apart from signaling the largest corporate bankruptcy in the USA, also raised a myriad of questions about the effectiveness of contemporary accounting, auditing and corporate governance practices (Vintern, 2002). Various commissions were formed (Blue Ribbon Committee (BRC), 1999; Treadway Commission, 1987) in response to corporate failure and reduced investor confidence in financial reporting, which culminated in the enactment of the Sarbanes-Oxley Act (2002). The Act was enacted to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes (Sarbanes and Oxley, 2002).

In the UK, various reports addressing the issue of corporate governance have been published (Greenbury Report, 1995; Turnbull Report, 1999; Higgs, 2003). The Cadbury Committee (1992) was constituted in response to the continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay, which had kept corporate governance in the public eye. The committee was formed to review those aspects of corporate governance specifically related to financial reporting and accountability. The committee's recommendation on financial reporting was that although listed companies publish full financial statements annually and half-year reports in the interim, in between these major announcements, boards may need to keep shareholders and the market in touch with their company's progress. The guiding principle once again is openness and boards should aim for any intervening statements to be widely circulated, in fairness to individual shareholders and to minimise the possibility of insider trading (Cadbury Committee, 1992).

Research also suggests that poor corporate governance contributes to dissatisfaction among stakeholders (Baydoun et al., 2013). Melyoki (2005) argues that the ability of a firm to attract investments depends on the effectiveness of its corporate governance systems, since this encourages investors to be confident that their investments will be protected and rewarded appropriately.

BANKING SECTOR IN KENYA

Background information about Kenya

Kenya, the gateway to East Africa, is strategically located on the Indian Ocean coast, thus providing easy access to regional and world markets. It borders Somalia, Ethiopia, Sudan, Uganda and the United Republic of Tanzania. It is aptly described as a land of contrasts, with 582,646 sq. km of beaches, desert, highly arable land, vast grasslands, forests, mountains and, of course, the Great Rift Valley, which runs through the country from the North to the South. (United Nations Conference on Trade and Development 2003).

According to the World Bank report (2016), Kenya has an estimated population of 46.1 million, which increases by one million a year. The official Kenyan currency is the Kenyan shilling and its capital city is Nairobi. With support of the World Bank Group (WBG), International Monetary Fund (IMF) and other development partners, Kenya has made significant structural and economic reforms that have contributed to sustained economic growth in the past decade. Development challenges include poverty and inequality, and vulnerability of the economy to internal and external shocks.

Kenya’s growth is projected to rise to 5.9% in 2016 and 6.1 % in 2017**.** The positive outlook is predicated on infrastructure investments. Fiscal consolidation is expected to ease pressure on domestic interest rates and increase credit uptake by the private sector. The contraction in the current account deficit will continue to be supported by declining commodity prices and rising exports of tea (World Bank 2016).

Sound monetary policy restored stability in the currency markets and contained the 12-month average overall inflation at 6.6% in December 2015. The Central Bank effectively managed currency volatility and running down Forex reserves to cushion the shilling. So, the Kenya shilling stabilized, and the depreciation moderated in comparison to other regional currencies (World Bank 2016).

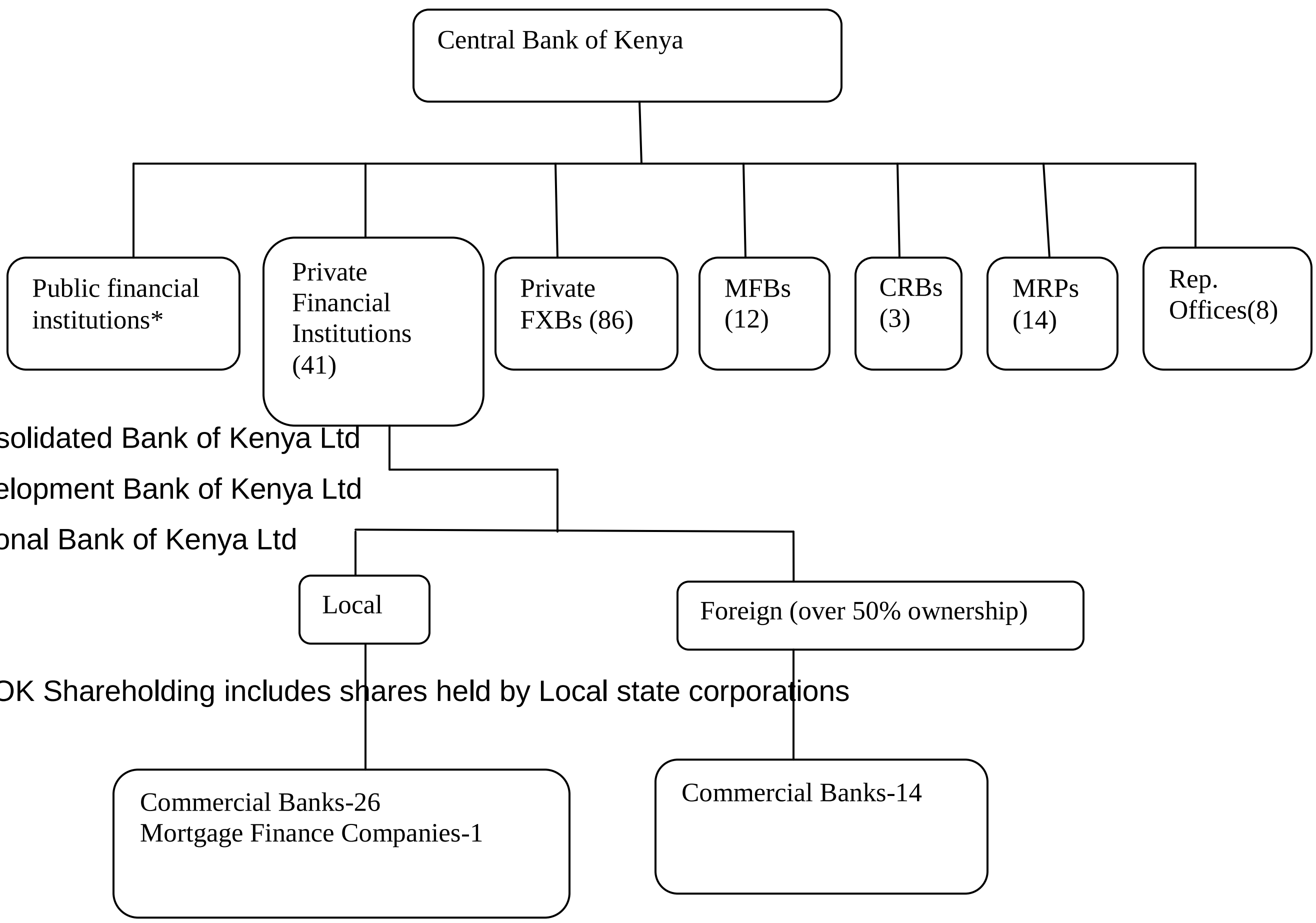
Low commodity prices had a net positive impact in Kenya in 2015. The gains through low oil prices and the rising earnings from tea have offset the loss in earnings from other exports (coffee and horticulture). As a result, the current account deficit contracted from 10.4% to 7.1% of GDP (World Bank 2016).

According to the October 2015 Kenya Economic Update, Kenya is poised to be among the fastest growing economies in Eastern Africa. Besides, the 2016 Country Economic Memorandum says that Kenya's growth prospects will depend a lot on Innovation, Oil, and Urbanization on the long term.

Overview of the banking sector in Kenya

As at June 30, 2015, the Kenyan banking sector comprised 43 commercial banks, 1 mortgage finance company, 12 microfinance banks(MFBs), 8 representative offices of foreign banks, 14 Money remittance providers(MRPs), 86 foreign exchange bureaus(FXBs) and 3 credit reference bureaus (CRBs).

Figure 1. Overview of the banking sector in Kenya



Consolidated Bank of Kenya Ltd

Development Bank of Kenya Ltd

National Bank of Kenya Ltd

*GOK Shareholding includes shares held by Local state corporations

Source: CBK Annual Report, 2015

According to the CBK Annual report for the year ended June 30, 2015, the Kenyan banking sector performance showed total assets standing at Ksh. 3.6 trillion(USD 36 billion), gross loans worth Ksh. 2.1 trillion(USD 21 billion), while deposit base was Ksh. 2.6 trillion(USD 26 billion). Profit before tax of Ksh. 76.7 billion (USD 767 million) was realized. The number of bank customer deposit accounts stood at 31.6 million. Capital levels stood at Ksh. 549 billion (USD 5.49 billion) while shareholders funds was Ksh. 543.3 billion (USD 5.433 billion). Gross non performing loans (NPLs) stood at Ksh. 123.9 billion (USD 1.239 billion) with the ratio of NPLs to gross loans being 5.7%.

Regulatory Framework

The Central Bank of Kenya has been at the forefront of improving corporate governance disclosure in banks and financial institutions. Through its Prudential Regulations and circulars, the Bank has greatly enhanced the depth of reporting by banks and financial institutions, particularly regarding bad loans portfolios and credit practices (United Nations Conference on Trade and Development 2003). The primary legislative sources of regulation in the banking sector are as follows:

- Constitution of Kenya (2010)
- Banking Act (August 2014) (the “Banking Act”)
- Central Bank of Kenya Act (January 2014) (the “Central Bank of Kenya Act”)
- Microfinance Act (2006)
- National Payment System Act (2011)
- Kenya Deposit Insurance Act (2012)

The main regulations and guidelines in the banking sector are as follows:

- Guideline on Non-Operating Holding Companies (2013)
- Guideline on Incidental Business Activities (2013)
- Risk Management Guidelines (2013)
- Prudential Guidelines (2013) (the “Prudential Guidelines”)
- Banking (Credit Reference Bureau) Regulations (2013)

Regulatory authorities

The Central Bank of Kenya (the “CBK”) has overall regulatory authority over the banking sector in Kenya. In the past few years, the CBK’s supervisory role has been strengthened by numerous revisions to the Banking Act, the Central Bank of Kenya Act and the Prudential

Guidelines. For instance, more legal powers have been given to the CBK by broadening the responsibilities and coverage of institutions by the Banking Act.

If the CBK has reason to believe that the business of a regulated institution is being conducted in a manner that is contrary to the provisions of the Banking Act, or in a manner which is not in the best interests of its depositors or members of the public, then it may give advice or make recommendations to the institution.

The CBK may also issue directions and implement measures to improve the management or business methods of the institution, or appoint a person to advise and assist the institution. The CBK has the power to appoint a manager if (1) an institution, for example, fails to meet any of its financial obligations, (2) a petition is filed for the winding-up of the institution, (3) the CBK becomes aware of any fact which warrants the exercise of its power, or (4) the institution is significantly undercapitalised. A manager so appointed has the power, inter alia, to assume management control of the institution to the exclusion of its board of directors, and declare moratorium on payments by the institution to its depositors and creditors.

CORPORATE GOVERNANCE IN KENYA

In Kenya, corporate governance has been addressed from two fronts. First, the Private Sector Corporate Governance Trust (PSCGT) in conjunction with the Commonwealth Association for Corporate Governance produced a sample code of best practice for corporate governance in June 2000. One of the key recommendations in the PSCGT (2000) code was that companies establish audit committees composed of independent Non Executive Directors (NEDs) to keep under review the scope and results of audit, its effectiveness and the independence and objectivity of the auditors. To improve on the quality of financial reporting, the guidelines extended the scope and duties of external auditors. Audit scope was extended to cover proper conduct of the company's affairs, the company's financial performance and position and future risks. The auditors' duties were extended to cover reporting whether the company has financial and other risky management controls, evaluating and reporting on aspects of propriety and efficiency and reporting directly to the board, regulatory authorities and shareholders as appropriate when illegal acts are discovered, and to monitor basic ethical behaviour particularly in regard to the public interest (PSCGT, 2000). Consistent with the King Report (1994), the PSCGT code has adopted the "inclusive approach" to corporate governance (Rossouw, 2005b).

Second, CMA issued guidelines on good corporate governance practices by public listed companies in Kenya in 2002. The guidelines were prepared in recognition of the role of good corporate governance in corporate performance, capital formation and maximization of shareholders' value, as well as protection of investors' rights (CMA, 2002). These guidelines were extensively borrowed from the UK Cadbury Report of 1992 and the South Africa King Report of 1994. Through Legal Notice No. 60, 2002, CMA issued guidelines on the board and board committees, shareholders and their rights, and top management.

According to the CMA guidelines: The board should be composed of a balance of executive directors and NEDs (including at least one third independent and NEDs) of diverse skills or expertise (but the guidelines are silent on the number of directors); There should be a clear separation between the role and responsibilities of the chairman and the chief executive officer; That directors' remuneration, which should be approved by the shareholders, should be sufficient to attract and retain directors to run the company effectively; All listed companies should at least establish an audit and nominating board committee.

The audit committee is charged with the responsibility of overseeing the internal and external audit functions, and reviewing of quarterly, half yearly and year-end financial statements of the company. The audit committee should have at least three independent and NEDs who shall report to the board, with written terms of reference, which deal clearly with authority and duties. Unlike the King Report, the CMA guidelines are not voluntary. The guidelines require that all listed companies should include in their annual reports statements of the directors as to whether their companies are complying with the guidelines. Where the company is not fully compliant, the board shall identify the reasons for non-compliance and indicate the steps being taken to become compliant (CMA, 2002). This is similar to the "comply or explain" approach that has been adopted by the JSE Listing Requirements (Mangena and Chamisa, 2008). However, unlike the King Report which adopted the "inclusive approach" to corporate governance, the CMA guidelines mainly focus on shareholder-wealth maximization.

Why corporate governance in the banking sector

Possibly no other set of firms has been as closely examined in the past few years as banks and financial institutions. Since the onset of the financial crisis in 2008, countless papers and policies have been proposed, discussed, and published on nearly every aspect of banking and finance. The bulk of this attention almost certainly springs from the financial crisis as a powerful reminder of the importance of the financial system. The financial crisis transformed into a grim reality the academic assertion that a healthy economy cannot exist without a well-functioning financial system.

Banks play an important role in the economy of a country. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation and stimulates productivity (Levine, 2004).

Levine (2004) argues that given the importance of banks, the governance of banks themselves assumes a central role. This is especially due to the following reasons:

Banking institutions are charged with upholding the public's trust and protecting depositors. Balance sheets are more opaque, leading to less transparency and greater ability to conceal problems. Good governance requires boards and senior management to fulfill their fiduciary responsibilities by effectively communicating strategic business direction and risk appetite while assuring transparent and effective organization, risk assessment and mitigation, and sufficient capital support.

Good governance complements traditional supervision of banking institutions, protects the interests of depositors and other investors in commercial banks, builds and maintains public confidence in the banking sector, and ultimately contributes to its integrity and credibility.

Banking institutions are uniquely vulnerable to liquidity shocks which can result in institutional, and potentially, financial instability. Sound governance supports prudential supervision and regulation, enhancing the role and the effectiveness of the banking institution supervisor.

Many developing countries are embarking on wide-ranging corporate governance reforms of their state-owned banks in order to improve their efficiency and transparency. Development banks are now playing a more prominent role in the economy of emerging markets. Development banks play a central role in financial inclusion, SME development and, housing, agriculture and infrastructure finance. Solid corporate governance allows these institutions to fulfill their mandates more effectively.

Kenyan Banking sector corporate governance guidelines

In Kenya, corporate governance Guidelines are issued under Section 33(4) of the Banking Act(2013), which empowers the Central Bank of Kenya to issue guidelines to be adhered to by institutions in order to maintain a stable and efficient banking and financial system.

Corporate governance guidelines are contained in the Prudential Guidelines for Institutions licensed under the Banking act (herein after called Prudential Guidelines). According to Prudential Guidelines (2013) , good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the institution and its shareholders, facilitate effective monitoring and define how an institution:

a) sets corporate objectives, including generating economic returns to owners;

b) runs the day-to-day operations of the business;

c) considers the interests of recognized stakeholders; aligns corporate activities and behaviors with the expectation that the institution will operate in a safe and sound manner, and in compliance with applicable laws and regulations;

d) And protects the interests of depositors.

According to the Guideline on Corporate Governance (CBK/PG/02), the purpose of the Guideline is to provide the minimum standards required from shareholders, directors, chief executive officers and management of an institution so as to promote proper standards of conduct and sound banking practices, as well as ensure that they exercise their duties and responsibilities with clarity, assurance and effectiveness.

The Guideline provides the following sound corporate governance principles that should be adopted by banking sector institutions:

Principle 1- Ethical Leadership and Integrity

The board should provide effective leadership based on an ethical foundation. Good corporate governance is essentially about effective, responsible leadership characterized by the ethical values of responsibility, accountability, fairness and transparency.

Principle 2- Responsibilities of Shareholders

Shareholders of banking institutions shall jointly and severally protect, preserve and actively exercise the supreme authority of the institution in general meetings. They have a duty, jointly and severally, to exercise that supreme authority.

Principle 3 - Overall responsibilities of the Board

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management.

Principle 4 - Role and competence of Board members

Board members should be and remain qualified, including through training and continuous professional development (CPD), for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank.

Principle 5 - Corporate Governance in a Group structure

In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

Principle 6 -Senior Management.

Under the direction of the board, senior management should ensure that the bank‟s activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.

Principle 7 - Risk Management Framework

The board must ensure that the banking institution has adequate systems to identify, measure, monitor and manage key risks facing the banking institution and adopt and follow sound policies and objectives which have been fully deliberated.

Principle 8 – Compliance with Laws, Rules, Codes and Standards

The board should ensure that the company complies with applicable laws and considers adherence to the institution's rules, codes and standards.

Principle 9 - Internal Control Functions

The board and senior management should effectively utilize the work conducted by internal audit functions, external auditors and internal control functions.

Principle 10 – Governance of Information Technology

The board should be responsible for Information Technology (IT) Governance. IT governance can be considered as a framework that supports effective and efficient management of IT resources to facilitate the achievement of a institution's strategic objectives. IT governance is the responsibility of the board.

Principle 11 - Bank's Operational Structure

The board and senior management should know and understand the bank‟s operational structure and the risks that it poses (i.e. "know-your-structure").

Principle 12 - Disclosure Requirements

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

Effectiveness of the corporate governance principles in the Kenyan Banking sector

Khanchel (2007) identifies independent directors, independence of board committees, board size, split chairman/CEO roles, board meetings, reputation of auditors and audit committee meetings as the main determinants of quality corporate governance.

Effective corporate governance and related accountability mechanisms are presumed to mitigate conflicts of interest and provide reasonable assurance that each party observes certain behavioural norms. One might expect that accounting would be well equipped to examine and prescribe improvements in accountability among agents in capitalist settings. The board of directors plays a key role in accountability, with the NEDs having the most crucial role. NEDs' role is to ensure that managers are accountable to the shareholders and that shareholders' interests are protected. According to Shapiro (2006), a higher proportion of non-executives on the board may increase controls on self-interested managers. Klein (1998) argue that independence is an important factor for a board committee to be an effective monitor and hence the need for more NEDs on corporate boards.

Consistent with the Cadbury Committee (1992), the King Report (2009) emphasizes the role of shareholders in enhancing corporate governance which is also captured in the Prudential guidelines on corporate governance that places a duty, jointly and severally, to the shareholders to exercise that supreme authority. It is arguable whether shareholders in the Kenyan banking sector ensure that persons elected to the board are credible. Do they for example conduct background checks on the persons to be elected to the board?

While the prudential guidelines on corporate governance bar government ministers and political leaders from being appointed as directors of the bank, they still influence who sits on these boards albeit indirectly. The political leaders exert influence on management decisions through, in certain cases, electing their own representatives to the board of directors (Malherbe and Segal, 2001; World Bank, 2003). Though not directors per se, they are able to exert influence on board activities. Thus, rather than being involved in monitoring and assessing the governance of the firms, 'shadow' directors become involved indirectly in the running of the firms (World Bank, 2003). This may lead them to have incentives to extract private benefits that are not available to other stakeholders (Shivdasani, 1993).

To improve corporate governance, Tsamenyi et al. (2007) have suggested measures such as increasing overall investor confidence through governance issues such as shareholder rights and increased transparency through higher levels of information disclosure. On disclosure requirements for the Banking sector in Kenya, it is arguable if they are adequately transparent to their shareholders, depositors and other stakeholders and market participants. Do all banks, for example, honestly disclose critical information related to their risk profile such as levels of non performing loans (NPLs)?

Research indicates that audit quality is an important element of efficient equity markets, because audits can enhance the credibility of financial information and directly support better corporate governance practices through transparent financial reporting (Chee Haat et al., 2008; Francis et al., 2003). According to DeAngelo (1981) and Beatty (1989), large public accounting firms with greater investment in reputational capital have more reason to minimize audit errors via "auditor-reputation effects". Furthermore, Dye (1993) argue that large audit firms are inclined to supply a higher quality audit compared to small firms, as more wealth is at stake in large audit firms. They will also experience a greater loss through reputation damage if the quality of their audit does not meet the accepted quality standards (Chee Haat et al., 2008).

Mitton (2002) argue that firms which are audited by one of Big-4 audit firms (a proxy for audit quality) are more likely to have a better market performance as well as greater transparency. In our view, in Kenya, mechanisms to apportion liability to audit firms in situations where corporate failures are as a result of the auditors' negligence and or collusion is still weak.

While the Prudential Guidelines requires that Board members must be persons of high integrity, this is not always the case in Kenya. Persons of questionable integrity have found their way into these boards through unorthodox means such as political considerations.

In the recent past, the integrity of the Central Bank of Kenya as the regulator of the Banking sector has been questioned. Pundits argue that it is not by coincidence that the recent change in the top leadership of the CBK has resulted in the closure of at least two banks. Could it be possible that the former regime at the CBK was condoning malpractices in the banking sector?

The banking sector regulatory framework in Kenya is majorly Principles-based. Principles-based approach to regulation stresses goals and objectives rather than the particular methods of achieving those ends. It is high time the government decides whether to stick with principle-based regulatory framework or adopt rules-based approach or maybe a hybrid of both. . Rules are typically thought to be simpler and easier to follow than principles, demarcating a clear line between acceptable and unacceptable behavior. Rules also reduce discretion on the part of individual managers or auditors, making it less likely that their judgments will be motivated by a desire to achieve personal gain at the expense of investors or the public. Despite the virtues of rules, in practice rules can be more complex—and, hence, even more murky—than principles. Since rules and principles each have their strengths and weaknesses, regulators sometimes try to combine them both in hybrid systems of regulation. (Coglianese et al,2004)

There is need to relook at the enforcement mechanism applied by the CBK as the regulator of the Banking sector in Kenya. According to Coglianese et al (2004), enforcement not only has major consequences for individual and corporate violators, but it also can affect the overall credibility of a regulatory system. Enforcement actions send a message to the broader public. They both deter bad actors and level the competitive playing field. That said, greater enforcement is not always better, for if taken too far it can dampen socially valuable risk-taking. As with any important policy tool, regulators need to know when and how to pursue enforcement actions, especially criminal prosecutions. The capacity of regulators, in terms of resources both human and material must be critically assessed.

CONCLUSION

Corporate governance instills policies and rules for maintaining the cohesiveness of an organization. It is meant to hold an organization accountable to her stakeholders while helping the organization steer clear of financial, legal and ethical pitfalls.

It is imperative that banks exercise good corporate governance due to its significant role in the economy of a country. Given the importance of the banking sector in a country's economy and the problems that have recently plagued the banking sector in Kenya, it is not surprising that the Central Bank of Kenya has been at the forefront of improving corporate governance disclosure in banks and financial institutions. Through its Prudential Regulations and circulars, the Bank has greatly enhanced the depth of reporting by banks and financial institutions, particularly regarding bad loans portfolios and credit practices.

The issue of public governance, which has largely been weak — particularly public policy and national economic priorities — and the broader issues of the national ideological framework, values, justice systems, ethics and social infrastructure that underpin the business environment must be addressed. The need for further legal, regulatory and policy reform is paramount. The capacity of regulatory authorities to enforce the law must also be addressed.

Due to the role corporate governance plays in ensuring economic efficiency, sustainable growth and financial stability there is need to review corporate governance in other financial sectors like Insurance sectors and Savings and Credit Cooperatives societies (SACCOs). A comparative study on whether to adopt Rules-based regulation or Principles-based regulation or a hybrid of both in the banking sector can also be conducted.

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