

**STRATHMORE UNIVERSITY
INFORMATION TECHNOLOGY DEPARTMENT
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MCS 8203: CORPORATE GOVERNANCE & ETHICS**

**A CASE STUDY ON CORPORATE GOVERNANCE ISSUES
FACING THE COMMERCIAL BANKING SECTOR IN
KENYA.**

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INTRODUCTION

Banks play a key role in the economy of any country by majorly assembling savings from surpluses and directing these funds to deficit accounts that is, industries or individual accounts for the purpose of increasing their production capacities.(Oghojafora, Olayemia, & Okolieb, 2010, p. 253) The concern over corporate Governance originates from the fact that good corporate governance habits increase a firm's market value, enhance profitability and lower the cost of funds. According to the Nairobi Stock exchange Feb 2011 bulletin the total number of shares issued by the end of Feb 2011 isKshs. 65.32 billion. All this money is stashed in banks investor accounts. This is just a fraction of the loss Kenya will have to bare incase the banking sector collapses. The concern over good corporate governance practices in banks is understandable.

While organizations exist to the primarily make profits they have other duties also. The Private Initiative for corporate governance defines corporate governance as the establishment of an appropriate legal, economic and institutional environment that allows companies to thrive as institutions for advancing long-term shareholder value and maximum human-centered development while remaining conscious of their other responsibilities to stakeholders, the environment and the society in general. (Private Sector Initiative for Corporate Governanace, n d, p. 2)

As the definition proposes, organizations have a wide spectrum of entities to be accountable to, with respect to their mission, and as such they need supervision and regulation. In Kenya the banking sector is regulated and supervised by the Central Bank of Kenya, which ensures that banks are governed according to the Banking Act (Chapter 488 of Kenya constitution). Other constitutional acts that provide governance regulations applicable to banks are; The Companies Act, The Capital Markets Authority Act and Nairobi Stock Exchange (NSE) Regulations and the Penal Code.

This is therefore an exploratory study, which seeks to understand and assess the quality of governance practices in commercial banking sector in Kenya.

PROBLEM STATEMENT AND OBJECTIVE

The choice of Commercial Banks as the focus of this study was informed by the significant role these institutions play in Kenya's economy.

In the recent past there has been considerable public outcry regarding commercial banking operations in Kenya as regards the economic issues that the sector has created or is poised to create: housing bubble burst, massive job cuts and loan interest inflation. The study aims to look into these issues through the eyes of some corporate governance and ethics principles; greed, fiduciary duties, stakeholder principle, common good and subsidiarity principle.

This paper intends to achieve the following objectives;

- a. To examine how banks have strayed from basic corporate governance and ethics principles; greed, fiduciary duties, stakeholder principle, common good and subsidiarity principle.
- b. To offer possible solutions to governance issues established.

PRESENTATION OF PROBLEM

The scope of this study is limited to the banking sector in Kenya consisted of 43 commercial banks, 1 mortgage finance organization and 3 deposit microfinance organizations as at November 30, 2010. (Central Bank of Kenya, 2010, p. 56)

The commercial banking case in Kenya presents three pertinent outcomes as a result of poor corporate governance. These are presented in the following paragraphs.

LOAN INTEREST INFLATION

The November 2010 monthly economic review from Central Bank of Kenya (CBK) indicates that in the ten months leading to November 2010, the banking sector recorded a 45.7-percent raise in before-tax profit: In November 2009 the profit figure was Kshs. 45.3 billion, this figure increased to Kshs. 66.0 billion at end of November 2010.

Looking at the banks' loan interest rates vis-à-vis interest rates paid on deposits, it is clear to see that banks made a substantial amount of this profit by charging more interest on their loans than they pay out to secure deposits.

Loan rates in commercial banks registered an increase; from 14.1 to 15.1 percent in June 2008 and June 2009 respectively. Consequently, interest rate spread (the difference between lending interest rate and deposit interest) increased from 9.4 percent to 9.8 percent in July 2008 and June 2009 respectively. (Central Bank of Kenya, 2009, p. 31). By the end of 2010 this value had increased further to 10.41 with banks e.g. Barclays bank charging as high as 14.69 percent. To compare this with its counterparts, Equity charged 13.12 per cent, Kenya Commercial Bank (KCB) 10.25 per cent and Stan-chart 8.80 per cent.

Banks' lending interest rates have continued to be high despite CBK's directive to lower the rates.

JOB CUTS

Analysts have observed that over the last decade, banks had their profits soaring, consequently costs increased as bank managers employed more workers without a proper and justifiable strategy. These workers would later be paid more money in huge salaries and bonuses cutting down bank profits to unsustainable levels. (Bonyo & Nyabiage, 2011)

With increased competition and heavy investment in technology, banks are rethinking of ways to increase revenue and cut costs. The target of restructuring has easily become bank employees. Kenya Commercial Bank (KCB) aims to cut operating costs by 20% and their target for this is the year 2013. KCB notes that this will unavoidably lead to job cuts. ("KCB Kenya - KCB Re-organizes Head Office...", n.d.). Barclays Bank of Kenya will drop two hundred mid-level managers from its pay roll as a result of restructuring. The bank says that this structure appraisal will help to align the workforce to the strategic goals of its business. Even though, only these two banks have owned up to the fact that a rapidly increasing salary cost is eating into profits, analysts say they are not the only banks facing a similar predicament. (Bonyo & Nyabiage, 2011)

Over the years dating back to 2005, commercial banks developed the need to have extensive grip across the country by rapid expansion in utter show of financial strength. The peak of this as seen in November 2007 annual report by CBK, is the year 2007 which recorded a 55% rise; banks opened a record of 165 new branches. CBK statistics shows that in the years after 2007 the rate of increase continued to drop, that is, in 2009 the figure dropped to 158 and in 2010 dropped further to 87 new branches opened. The brick and mortar model was quickly losing appeal.

Analysts point the drop in growth of new branches to the speedy uptake of mobile phone banking. But bank management did not initially envisage the reduced rate of growth in branches as they disapproved mobile banking services. At present, the service has much advantage to banking; enabling customers to move money within bank accounts, pay for goods and services, and receive and send money.

Consequently banks have moved to take advantage of these services through partnerships with mobile service providers e.g. Family Bank's Pesa Pap, Equity Bank's M-Kesho with Safaricom and Barclays "Hello Money". According to CBK, mobile banking services have facilitated the enlistment of over 700 thousand customers and mobilize over KShs400 million in deposits.(Central Bank of Kenya, 2010)

In 2007 when money transfer service M-Pesa was launched, banking industry complained that the service was contending with them arguing that in Kenya M-Pesa was untenable, unreliable and unregulated. Consequently banks continued with rapid brick and mortar expansion. Clearly, bank management failed to see mobile banking as complementary to business instead choosing to see it as a competition.

HOUSING BUBBLE

It is common to hear that housing or land prices in Kenya will always go up and can never go down and that one can never fail if they invest in real estate in Kenya. Is this really true, and if true will it always be true?

According to the Central Bank Mortgage Report, (Central Bank of Kenya & World Bank, 2010Nov)the following excerpts can be derived;

- The average mortgage loan size has been steadily increasing. On average, the new mortgage loan size is approximately Kshs. 6 million. A reserve for the rich.
- The total mortgage loan book in the country is only 15049 accounts, while the total value of mortgage loans, as at the end of December 2010 was Sh133.6 billion. This means that, technically, only 15049 people or organizations in the whole of Kenya have taken up mortgages. It could also be an indication that buying property in Kenya is a reserve of the rich, who choose cash sales as opposed to mortgages.

- The mortgage loan market is concentrated by having the top five lenders represent over 80% of the total mortgage portfolio. In case customers were to default in mass, the losses will be concentrated and would lead to collapse in the same way as Lehman Brothers in the USA.
- When applying for loans, 25% of banks reported that personal guarantees were not required for collateral. Several banks also noted that the first legal charge and personal guarantees were sufficient for collateral. These forms of unsecured loans are high risk to banks.

Professionals in the housing sector say the findings reflect the high level of speculation on land and housing that has pushed property prices through the roof. This combined with high risk lending and high inflation will eventually lead to a housing bubble burst. (Ondieki, 2010)

Economic bubble can be defined as sharp rise in price of an asset in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers. Generally, speculators are interested in profits from trading in the asset rather than its use or earning capacity. The rise is usually followed by a reversal of expectations and a sharp decline in price often resulting in financial crisis. (Siegel, 2003, p. 11)

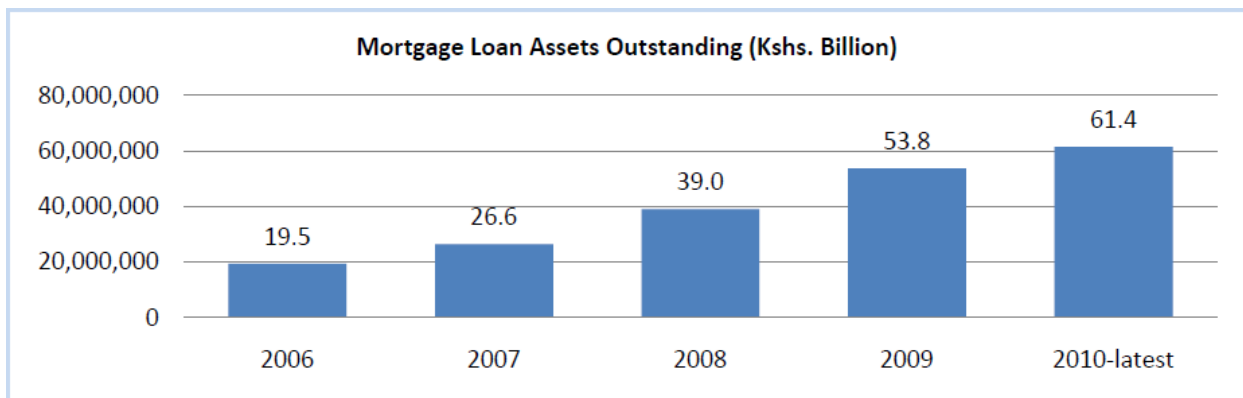


Fig 1: Mortgage loan assets have continued to rise over the years. (Central Bank of Kenya, 2010). This shows that banks have continued to lend more in term of loans.

ANALYSIS OF CASE

The theme of *greed* clearly stands out where Banks have an interest spread of up to 14.69 percent despite calls by CBK to lower the rates. Bank management is clearly aware of the impact of high interest rates on the economy i.e. low economic investment and encouraging speculation leading to high priced goods yet Banks continue to charge interest according to whim. The bank's responsibility to the customer and economic environment as seen in the *stakeholder* principle is discarded to favor appetite of shareholders and executives. Central Bank of Kenya is responsible for bank supervision. It should lobby more for legislation that would strengthen its supervisory and monetary control to ensure that rogue banks do not impose economically harmful policies.

The board has a responsibility to see to it that management has adopted a sound strategy and executes it competently. As banks fought mobile banking in Kenya, banks in other countries were making profits out of mobile banking partnerships. An article in a mobile journal in 2007 notes: "Absa Bank launched the first commercial mobile banking solution in South Africa 2002. Absa claims that more than 300 000 subscribers have enrolled for the service to date. This early launch has been followed up with launches of different types of solutions from Standard Bank, FNB, Investec and others with a rough estimate of more than a million mobile banking subscribers. This is amazing if one considers the short time that mobile banking has been available." ("Mobile Banking: Mobile banking in Africa," n.d.). However banks failed to see this and continued with the brick and mortar strategy that is now costing them far much more compared to mobile banking. At Common Law directors have a *duty of care* to show reasonable competence. They failed to envision the need of technology partnership and now employees are paying through massive job cuts.

In the past five years banks strategy has been growth and expansion, increased employment opportunities and increased returns / dividends. The present scenario is restructuring and downsizing with the aim of increasing shareholder returns. Barclays bank for example increased its dividend payout to a whopping 172% i.e. from Kshs2 in 2009 to Kshs5.45 per share in 2010. Equity Bank doubled its dividend payout to

KShs0.80 while KCB increased its payouts by 25 per cent to KShs1.25. (Gachiri & Michira, 2011). Bank directors have pointed out that the main reasons why they have preferred to downsize employees is competition from other banks and to improving operational inefficiencies. As banks expanded, management become increasingly derailed from the path that ensured employees were developed and utilised. They concentrated on competition and *maximising shareholder* value at the expense of making knowledgeable decisions about how resources and returns should be distributed to enhance strategies hinged on retaining employees and reinvesting profits to succeed. For example, banks do not pay much attention to research and development. Banks have also succumbed to *agency* theory: the market is more efficient at the distribution of resources than the organisation and that senior executives who do not deliver increase in share price will be ridiculed in the financial press.

According to *stakeholder theory*, are not also employees entitled to a say on how the firm allocates resources? Employees create the economic value by putting their blood sweat and tears into the organization.

The consequence of restructuring is that banks have not acted in the *common good* including that of their employees: Restructuring has caused worker insecurity, anxiety, reduced motivation and denied the knowledge transfer as a result of high turnover.

The mortgage industry in Kenya is has been perceived to be approaching a bubble burst as demand exceeds supply and suppliers become more greedy. Houses are being sold to the rich who have the power to maintain a monopoly and speculate on the price of property thus keeping prices up. According to the *principle of subsidiary*, Government has a duty to provide for the lower level societies such as families in those necessary needs that they cannot cater for themselves. With the increase in property prices the Government has a duty (in this case via National Housing Corporation) to limit certain kinds of house purchases to low income earners and close off greedy speculators. If the Government does not intervene,

then high property rates compounded with high mortgage (loan) interest rates and less strict loan requirements could generate a housing bubble burst.

CONCLUSION

This study has looked into corporate governance and ethics issues that face banking sector in Kenya. Three areas were given most consideration; loan interest inflation, job cuts and mortgage crisis. This is because these three areas are considered to generate the most impact on the economy and the dignity of individuals and society if they are left unchecked. One of the greatest impacts on economy is inflation, where the price of goods and services rise above the reach of ordinary citizens. When they cannot adequately meet the most basic needs food, clothing and shelter because their right to do so has been swallowed by institutions they trust but they fail to protect them.

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