Strathmore University
SU+ @ Strathmore University Library

Electronic Theses and Dissertations

2019

Engendering good corporate governance in the Kenyan banking sector: an examination of the limits of law

Moses B. Obonyo
Strathmore Law School (SLS)
Strathmore University

Follow this and additional works at https://su-plus.strathmore.edu/handle/11071/10171

Recommended Citation

Obonyo, M. B. (2019). *Engendering good corporate governance in the Kenyan banking sector: An examination of the limits of law* [Thesis, Strathmore University]. https://su-plus.strathmore.edu/handle/11071/10171

This Thesis - Open Access is brought to you for free and open access by DSpace @Strathmore University. It has been accepted for inclusion in Electronic Theses and Dissertations by an authorized administrator of DSpace @Strathmore University. For more information, please contact librarian@strathmore.edu

Engendering Good Corporate Governance in the Kenyan Banking Sector: An Examination of the Limits of Law

Obonyo, Moses Buyuka

Submitted in Partial Fulfilment of the Requirements for the Award of Degree in Master of Laws at Strathmore University

Strathmore Law School

Strathmore University

Nairobi, Kenya

June, 2019

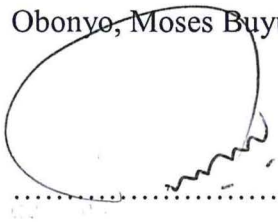
This thesis is available for Library use on the understanding that it is copyright material and that no quotation from the thesis may be published without proper acknowledgment.

DECLARATION

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other University. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.

© No part of this thesis may be reproduced without the permission of the author and Strathmore University

Obonyo, Moses Buyuka



.....

20.06.19

.....

Approval

The thesis of Obonyo, Moses Buyuka was reviewed and approved by the following:

Dr. Joy Malala
Adjunct Lecturer, Strathmore Law School,
Strathmore University

Dr. Luis G. Franceschi
Dean, Strathmore Law School,
Strathmore University

Professor Ruth Kiraka
Dean, School of Graduate Studies
Strathmore University

ABSTRACT

Over the course of the past decade corporate governance has grown in importance across the institutional landscape. We have witnessed heightened expectation from stakeholders on matters of credibility and accountability from those charged with the management of institutions. This practice is exemplified in the banking sector with the populace demanding more stringent controls to ensure that the custodians of their funds are held to the highest standards of accountability. However, regardless of the enforcement of rules and principles of corporate governance in the banking sector, there have been visible cracks in the area of enforcement, which have led to several bank failures. The resultant effect of this is the loss of billions of shillings in depositor funds. This paper aims to explore corporate governance in the Kenyan banking sector with a focus on the limits of the law in its enforcement.

KEYWORDS

Banking, banking sector, corporate governance, incentives, incentive-based, negative incentives, principles of corporate governance, corporate governance and the law.

Table of Contents

LIST OF ABBREVIATIONS

CBK	Central Bank of Kenya
CEO	Chief Executive Officer
CMA	Capital Markets Authority
ERISA	Employee Retirement Income Security Act
ICPAK	Institute of Certified Public Accountants of Kenya
IFC	International Finance Corporation
KNAC	Kenya National Assurance Company
KPTC	Kenya Posts and Telecommunications Corporation
NBFI's	Non-Bank Financial Intermediaries
NSE	Nairobi Securities Exchange
OECD	Organisation for Economic Co-operation and Development
SWF	Sovereign Wealth Funds
TCE	Transaction Cost Economics
US	United States of America
UK	United Kingdom

ACKNOWLEDGEMENTS

I take the earliest opportunity to give thanks to God Almighty for granting me good health for the entire period of my studies.

To the Strathmore Law School faculty for creating an enabling learning environment under the leadership of Dr. Luis G. Franceschi and the able guidance of Dr. Peter Kwenjera and Dr. Osogo Ambani.

I am eternally grateful to my supervisor Dr. Joy Malala who was instrumental in ensuring that I completed the task at hand and on time. She was simply a joy to work with.

To my External and Internal Examiners, Dr. Celestine Musembi and Prof. Sylvia Kang'ara, respectively, for their insightful input and guidance at the thesis defence stage of my studies.

I am indebted to the Strathmore Law School Administration staff – Ivy Manyasi, Lucy Kithinji, Whitney Mbogori and Maryanne Magiri for their invaluable support.

DEDICATION

To Betty, Lora and Paula.

CHAPTER ONE

Introduction

1.1. Background

The 21st Century has been characterised by an exponential growth in the corporate landscape. This has in turn precipitated the growth of regulatory frameworks to ensure the proper functioning of these institutions. This state of affairs is exemplified in the banking sector with public interest necessitating the implementation of a stringent regulatory framework to protect depositor funds.

It is imperative to point out that corporate governance is not an alien concept. The United Kingdom (UK) began implementing codes of corporate governance in 1992 with the *1992 Cadbury Report.*[1] The Cadbury Report was authored by the Committee on Financial Aspects of Corporate Governance, now referred to as the Cadbury Committee.[2] The committee was set up in May 1991 by the Financial Reporting Council and the accountancy profession to address the financial aspects of corporate governance.[3] Sir Adrian Cadbury was the chair of the committee. He and this committee produced the Cadbury Code, which has since become the cornerstone of corporate governance.

The code is credited with defining corporate governance as 'the system by which companies are directed and controlled' as well as asserting that the codes are based on principles of accountability, openness and integrity.[4] Perhaps the most significant factor in the elevated status of corporate governance globally was the collapse of a number of high profile companies.[5] This can in large part be linked to the many instances of conflicts of interest amongst the members of boards running companies.

---

[1] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992.
[2] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992.
[3] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para. 2.1.
[4] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 2.5 and 3.2.
[5] Aras G and Crowther D, *A handbook of corporate governance and social responsibility*, Routledge, New York, 131-132.

Initially, complying with the rules was optional for the companies but this was later changed by the requirement from the London Stock Exchange that companies 'comply or explain' hence conferring the rules with statutory force.[6] The principle of comply or explain refers to a mechanism that combines voluntary compliance with corporate governance codes and a legal obligation to declare compliance with or explain deviations from a code.[7] Essentially, companies may choose not to apply the code and instead just give a description of their corporate governance practices. Kenya has essentially adopted the same 'comply or explain' approach with the exception that there exists some mandatory rules.[8] The rules of corporate governance that apply in the country have been set out in the Code of Corporate Governance for Issuers of Securities to the Public (2015) issued by the Capital Markets Authority (CMA) through a gazetted notice.[9] This was the result of a collaborative effort between the CMA, the World Bank Corporate Governance team and the International Finance Corporation's (IFC) Africa Corporate Governance Program.[10]

Despite the promulgation of these rules and principles, Kenya has witnessed the collapse of at least three mid-tier banks: Dubai,[11] Imperial[12] and Chase.[13] These failures can largely be attributed to lapses in the corporate governance framework. The failure of Chase Bank can be narrowed down to irregular insider lending at the behest of the directors while the straw that broke the camel's back at Imperial Bank was a conspiracy between bank officials to defraud depositors.[14]

---

[6] University of Cambridge, Judge Business School, the Cadbury Report: http://cadbury.cjbs.archios.info/report on 13 June 2018.

[7] Fasterling B, 'The Comply or Explain Approach: Company Law's Conformist Transparency' 23(2) *Reveu Internationale De Droit Èconomique*, 2009, 129.

[8] The Code of Corporate Governance Practices for Issuers of Securities to the Public 2015, The Capital Markets Act (Cap 485A), Gazette Notice No 1420, para 2.1.

[9] Kenya Gazette Notice No 1420, March 4 2016.

[10] Njuguna A, 'The evolution of corporate governance and consequent domestication in Kenya' 7 *International Journal of Business and Social Science* 5, 2016, 160.

[11] Joshua Masinde, 'CBK orders closure of Dubai Bank,' Daily Nation, 24 August 2015.

[12] Quartz Africa, Exotic holidays, gifts and the 380 million dollar fraud that brought down a Kenyan bank: https://qz.com/864182/exotic-holidays-gifts-and-the-380-million-fraud-that-brought-down-a-kenyan-bank/ on 13 June 2018.

[13] Mutuma Mathiu, 'Gloom for depositors as Chase Bank collapses,' Daily Nation, 7 April 2016.

[14] Daily Nation, 'How whistleblower's secret note to investors brought Chase Bank to its knees' April 10 2016.

The failure of these banks has not only impacted depositors negatively but has affected the banking sector in its entirety. These cases have a direct linkage with the moratorium that is currently in place instituted by the Central Bank of Kenya on the licencing of new banks in Kenya.[15]

The purpose of this study is to address the failures evident in the banking sector attributable to laxity in the corporate governance regime. The paper will interrogate the merits and efficacy of the code of corporate governance bearing in mind the limitations of the law in enforcing it. The paper will hypothesize on whether an incentive-based approach to the question may not in reality be more successful than the rule-based approach currently in effect.

The need for a robust corporate governance framework can be justified by the growth of institutions and the need by the public that its interests be protected. The literature on the topic has increased exponentially in tandem with the growing number of institutions. The theories on what makes an efficient corporate governance framework have also mushroomed globally. This paper aims to explore the various facets that impact the spectrum of corporate governance with a view to getting a better understanding of the corporate governance landscape in the country.

1.2. Problem Statement

The 'comply or explain' framework, a mechanism that combines voluntary compliance with corporate governance codes and a legal obligation to declare compliance with or explain deviations from a code, is a part of the narrow self-regulatory approach taken by Kenya and has failed to forestall the collapse of banking institutions such as Dubai Bank, Imperial Bank and Chase Bank. The failures of these banks are directly attributable to the narrow self-regulatory approach.

1.3. Hypothesis

The collapse of banking institutions such as Dubai Bank, Imperial Bank and Chase Bank is attributable to a narrow self-regulation approach to corporate governance.

---

[15] Central Bank of Kenya, *Declaration of Moratorium on Licencing of Banks,* 17 November 2015.

1.4. Research Objectives

a. To analyse the existing corporate governance regulatory regime in Kenya in order to demonstrate that it takes a narrow self-regulatory approach.
b. To prove a link between Kenya's narrow self-regulatory approach to corporate governance and the collapse of banking institutions such as Dubai Bank, Imperial Bank and Chase Bank.
c. To demonstrate the contrast between a self-regulatory approach and a government regulation approach.

1.5. Research Questions

a. What is the existing corporate governance regulatory regime in Kenya?
b. Is there a link between Kenya's narrow self-regulatory approach to corporate governance and the collapse of banking institutions such as Dubai bank, Imperial Bank and Chase Bank?
c. What is the difference between a self-regulatory approach to corporate governance and a government regulation approach?

1.6. Methodology

This study will employ a number of methods in order to collect the information necessary from which to draw conclusions. These shall constitute qualitative, quantitative, co-relational and meta-analysis. These methods have been chosen as the author believes they will be of assistance in the different facets of this study.

The qualitative method will utilise observations and document review where necessary. This will be useful in assessing the current status of corporate governance regimes in Kenya as well as across the globe. Observation will be necessary in evaluating the current corporate governance practices across Kenya and what impact they have had on institutions that employ them. It will be necessary, as well, in gauging whether the political climate across the region will be a suitable incubator for the implementation of an incentive-based approach. Document review will be the most extensively used research method as it will offer crucial information on how an incentive-based approach has been employed in other jurisdictions, its efficacy and pitfalls as well as how best to adapt it to our situation.

To achieve this, the study will dedicate a chapter to a comparative study of corporate governance regulation in the US, UK and Kenya. The comparative study will facilitate an inquiry into the practicality of any proposed approach from an implementation perspective.

The author in analysing the cause and effect aspects of this study will employ the co-relational analysis. An example of this will be in determining the relation that the employment of the incentive-based approach would have on institutional policies or how it might affect public confidence and as a result positively increase investment and number of investors and depositors. The author acquiesces that this means will generate projections and inferences hence cannot be 100% accurate but will offer a picture of the landscape after the implementation of an incentive-based approach to corporate governance.

The author will lastly employ the use of meta-analysis in this study. This will allow the synthesis of data from multiple studies and aim to draw a single conclusion from them. The author foresees the need to employ this method in assessing the attendant pitfalls of an incentive-based approach as well as in analysing the success in its implementation.

1.7. Literature Review

In analysing the literature on corporate governance, the study proposes to use a three-pronged approach. This paper will begin by defining the status quo of corporate governance across Kenya. This will be in the first section comprising three sub-sections. The first will attempt to elucidate the meaning of corporate governance as it is understood globally; the second will explore the visage that corporate governance has taken in Kenya and the third will attempt to review the pitfalls and failings of the current system of corporate governance.

The second part will have two sub-sections: the first will explore the meaning of an incentive-based approach as proposed in this paper and the second will highlight the rationale behind the push for its implementation. The last section will delve into the justification for the implementation of an incentive-based corporate governance regime in our jurisdiction. It will explore the impediments and challenges in the implementation

of an incentive-based approach and the steps that should be taken for it to succeed. The author aims to present a comprehensive yet concise study that seeks to evaluate whether an incentive-based approach would cure the current ills that pervade corporate governance in the country.

1.7.1. Understanding the meaning of corporate governance

The status of corporations across the globe has significantly risen in the past decade. It is at odds with the view previously taken of the responsibilities and liabilities of corporations and institutions. We have moved further and further away from the likes of Sir Edward Cooke who asserted that 'corporations cannot commit treason nor be outlawed as they have no souls'.[16] The public believe that corporations are responsible and liable and if there be a hangman's noose then they should not be exempt from the gallows. The question that now plagues those who cry foul at the actions of corporations is how to ensure that justice is meted out against an entity that only exists in the realm of the law. Coglianese opined that the answer to this conundrum will assume the form of improved government controls in the manner of reformed regulatory systems as well as an improvement in law enforcement.[17]

The Cadbury Report of 1992 defined corporate governance as 'the system by which companies are directed and controlled'.[18] The OECD added to this definition by surmising that 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.[19] The initial purpose of codes of corporate governance and their implementation was to promote a higher standard of governance and strove to ensure that boards of directors were efficient and accountable in the discharge of their duties. Gakeri proposes that the evidence from developed jurisdictions indicates that this efficiency is inextricably linked to the legal and regulatory framework in place.[20] These sentiments

---

[16] *Case of Sutton's hospital* (1612), United Kingdom Court of Excheqeur.
[17] Coglianese C, Healey T., Keating E and Michael M, 'The role of government in corporate governance,' John F Kennedy School of Government, 2004.
[18] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 2.5 and 3.2.
[19] OECD, *Principles of corporate governance*, 2004.
[20] Gakeri J, 'Enhancing Kenya's securities markets through corporate governance: Challenges and opportunities, 3(6) *International Journal of Humanities and Social Science*, 2013, 94-117.

echo those of the Institute of Directors South Africa in their assertion that good governance and the law cannot be separated.[21]

1.7.2. The Link between Corporate Governance and Bank Failure

The claim that bank failure and corporate governance failure are inextricably linked is by no means far-fetched and there is sufficient literature to back it. Good corporate governance is vital for any company and banks are no exception. In fact, there exists the argument that due to the differences in the economics and functions of banks from other industrial firms, banks are prone to more stringent regulation of their capital and risk.[22] These differences are also reflected in corporate governance of banks which include; high powered incentives (discussed in this paper) among others.[23]

The financial crisis in 2007 serves to highlight the importance of corporate governance to banks more than anything else. Several fact-finding studies have concluded that the poor corporate governance of banks was one of the major causes of the financial crisis.[24] The G20, the European Union and the Association of Chartered Certified Accountants all came to the same conclusion; 'corporate governance failure was one of the most important failures of the crisis.'[25]

There is no doubt of course that there were many other factors contributing to the financial crisis; low interest rates, high leverage, misallocation of investment, unsatisfactory rating practices, insufficient supervision by financial regulators.[26] However, given the studies cited above it is impossible to ignore the link between corporate governance failure and bank failure given what happened in the financial crisis of 2007. Concurrently, analysis on Zimbabwe's unprecedented catastrophic financial failure between 2003 and 2009 provides further evidence on the link between bank failure and corporate governance failure. The study conducted on Zimbabwe sought to find out if there existed any link at

---

[21] Institute of Directors in Southern Africa, *Draft code of governance principles for South Africa*, 2009.
[22] Mülbert P, 'Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms',2010, 3, ECGI Law Working Paper 130/2009, <http://ssrn.com/abstract=1448118>
[23] Mülbert P, 'Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms',3.
[24] Mülbert P, 'Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms',9.
[25] Mülbert P, 'Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms',9.
[26] Rose C, 'The Relationship Between Corporate Governance Characteristics and Credit Exposure in Banks: Implications for Financial Regulation' 43 Eurpoean Journal of Law and Economics 1, 2017, 167.

all between bank performance, let alone bank failure, and corporate governance. Their findings were surmised thus; 'there is enough evidence to conclude that corporate governance has a positive relationship with commercial banks in Zimbabwe.'[27] The same can be said of corporate governance anywhere as seen with the reports on the financial crisis of 2007; its failure inevitably leads to bank failure.

1.7.3. Corporate Governance in Kenya

The corporate governance sphere in Kenya borrows heavily from the code of corporate governance in the UK, with the former mirroring the latter to a fault. Currently, Kenya's corporate governance regime is regulated by The Code of Corporate Governance for Issuers of Securities to the Public (2015). It was issued by the Capital Markets Authority (CMA) and was the result of a collaborative effort between the CMA, the World Bank Corporate Governance team and the IFC's Africa Corporate Governance Program.[28] The Code enshrines the same principles extoled by the UK's Cadbury report and is in large part purely suggestive but for a small set of mandatory rules. This includes but is not limited to:

- that there be a clear division of responsibilities at the top, primarily that the position of Chairman of the Board be separated from that of CEO, or that there be a strong independent element on the board;
- that the majority of the Board be comprised of external directors;
- that remuneration committees for Board members be made up in the majority of non-executive directors; and
- that the Board should appoint an Audit Committee including at least three non-executive directors.[29]

---

[27] Njuguna A, 'The evolution of corporate governance and consequent domestication in Kenya' 7(5) *International Journal of Business and Social Science*, 2016, 160.
[28] Njuguna A, 'The evolution of corporate governance and consequent domestication in Kenya' 7(5) *International Journal of Business and Social Science*, 2016, 160.
[29] The Code of Corporate Governance Practices for Issuers of Securities to the Public 2015, The Capital Markets Act (Cap 485A), Gazette Notice No 1420, para 2.1.

Before Kenya adopted and instituted the code of corporate governance, guaranteeing accountability in the public sector was alien; this situation only changed following the liberalisation of the economy in the 1990's.[30] The situation at the time can aptly be defined as institutionalised inefficiency. It was riddled with the failures of various corporations amongst them 33 banks in the 1980's alone.[31]

An attempt to rectify this and guard against the failure of other banks came in the form of the promulgation of the Code of Corporate Governance for Public Listed Companies in 2002 the impetus of which was a corporate scandal.[32] However the failure of this code can be attributed to its practical inefficiency that was in part a result of the leniency in the penalties provided for flouting the rules.

1.7.4. Pitfalls of the Current Corporate Governance Regime in Kenya

We fix things because we reach the conclusion that they are not functioning as they are. A paper of this nature would be unnecessary if we perceived that the current corporate governance structure was living up to the public's expectations. However, the current moratorium on the licencing of new banks in Kenya that has been in place since 2015 seems to point to the converse.[33] The moratorium was instituted by the Central Bank of Kenya (CBK) after the failure of Chase Bank, Dubai Bank and Imperial Bank with the rationale being that it would allow the time required to strengthen the regulatory and supervisory framework of the CBK with regard to its oversight role in the banking sector.

It may be of use to the discussion to isolate and attempt a focused view on the factors that eventually influenced the collapse of the three banking institutions. Gathaiya surmised the factors that led to the eventual collapse of Chase Bank could be distilled to the twin factors of failure to meet the statutory capital adequacy ratio and under-reporting of insider loans.[34]

---

[30] Dignam A, 'Exporting corporate governance: UK regulatory system in a global economy', 21(3) *Comp L*, 2000, 70-72.
[31] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 19(7) *Social Science Research Network*, 2008.
[32] Du Plessis J, Hargovan A, Harris J and Mirko B, 'Principles of contemporary corporate governance', 2005, 6-7.
[33] Central Bank of Kenya, *Declaration of Moratorium on Licencing of Banks,* 17 November 2015.
[34] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 7(3) *International Journal of Management and Business Studies*, 2017, 9.

The insider loans totalled Ksh. 13.62 billon which was in sharp contrast to the official reported figure of Ksh. 5.72 billion.[35] This ultimately led to the inability of the bank to meet its financial obligations and its being placed in receivership in April 2016.

The fall of Dubai Bank was in many ways similar in form to that of Chase Bank. The Bank was established in Kenya in 1982 and was eventually placed in receivership in August 2015 by the Central Bank of Kenya.[36] This was a result of deficiencies in capital and liquidity: the bank had been breaching its daily cash reserve ratio.[37] The Bank also failed to honour some of its financial obligations such as paying off the debt it owed to the Bank of Africa. This eventually saw its liquidation after an assessment indicating that the magnitude of its problem placed it outside the realm of salvation.[38]

Imperial Bank commenced operation as a commercial banking service provider in the year 1996. As of December 2013, the bank ranked as the 19th largest Kenyan bank with its assets totalling 43 billion Kenyan shillings.[39] The fall of the bank begun in 2015 when the CBK placed it under statutory management. The bank was placed in receivership owing to unsafe and unsound practices and conditions of transacting business.[40] In 2016, NIC Bank was eventually selected as the asset and liability consultant for Imperial Bank and was made responsible for returning funds to the depositors of Imperial Bank.[41]

These isolated incidents are indicators of a far greater malady that lies at the heart of the corporate governance framework in the country. A weak and ineffectual regulatory and supervisory framework is one of the key stumbling blocks that may contribute to the fall of banks. An instructive way to highlight this is to analyse the oversight mechanisms deployed by a bank. Dubai Bank is a case in point, by the time it was collapsing it had only three directors overseeing its monitoring.[42]

---

[35] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[36] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[37] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[38] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[39] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[40] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[41] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',9.
[42] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',11.

Another factor that plays a major role in determining the success or failure of a bank rests on transparency and disclosure. From the case of Chase Bank, we see that this was the Achilles' Heel of its eventual collapse. The bank chose to under report non-performing loans as well as employing special purpose vehicles to siphon billions of shillings.[43] This undermined one of the three principles of corporate governance, openness, and the Bank's failure was inevitable.

The issue of integrity is also brought to the fore when analysing the failure of these banks. The founder and chairman of Dubai Bank, Hassan Zubeidi, accumulated vast wealth through irregular insider lending that he subsequently covered up by doctoring the books of account. This state of affairs was replicated at Chase Bank where the Chairman and his co-Director were found to have drawn funds from the lender and funnelled them to the entities they co-owned.[44] The CBK eventually seized property worth Ksh. 7.9 billion camouflaged as Joint Islamic Ventures. These properties were eventually charged to Chase Bank paving the way for the re-opening of the bank.[45]

1.7.5. Incentive-based Approach to Corporate Governance

The 'comply or explain' framework falls short of its mandate because it does not give sufficient impetus for companies or institutions to comply. Other than the mandatory laws that are given force through statute, the other rules serve at best as pointed suggestions towards giving leeway for companies to decide whether or not to be bound. The import of an incentive-based approach is that it offers sufficient reason to entice compliance from institutions. The current incentive that is linked to company listing in the Nairobi Securities Exchange allows corporations to disregard the laws with impunity or flout them at will. The following sections will attempt to explore the rationale behind incentive-based corporate governance and the form that it would take if it is to be effective.

---

[43] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',11.
[44] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',11.
[45] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',11.

1.7.6. Understanding incentive-based corporate governance

Incentive is defined as a thing that motivates someone to do something.[46] There are two distinct forms of incentives, positive incentive and negative incentive with the former being the more popular. A negative incentive will penalise bad behaviour whereas a positive incentive rewards good behaviour. The current structure of corporate governance has opted to lean heavily towards the application of positive reinforcement. Listing on the NSE as the carrot-dangling-on-a-stick as reward for complying with the rules set out in the code of corporate governance is one such tactic of positive reinforcement. This paper recognises that incentives are in fact in use as a means of effecting corporate governance however it proposes that the employment of negative incentives may yield more success than is currently seen in the banking sector. The grounding of this theory lies under the ambit of behavioural economics and the theory of loss aversion. The theory of loss aversion states that people would go to twice the length to avoid losses than to ensure gains.[47] The theory has been used to support the assertion that penalty frames may be more effective than reward frames in motivating people.[48]

The inspiration for this approach may be credited largely to the Code of Hammurabi. The code was set out by King Hammurabi about 4000 years ago and was one of the first sets of laws.[49] The import of the code to the discussion does not rest as much on the laws it set out but rather the incentives it provided to ensure that they were adhered to. Of note are the construction laws and the penalties they set out; these were designed to ensure that contractors built safe homes. The underpinning rationale set out that for each life lost due to a fault in construction, a life would be owed. An example is law which provided that if a house collapsed and killed the occupant of the home, the builder would be put to death.[50] The lesson that the Code of Hammurabi brings to modern corporate governance is that steeper penalties engender better practices. Nassim Taleeb echoed these sentiments by

---

[46] https://en.oxforddictionaries.com/definition/incentive on 7 July 2018.
[47] Kahneman D and Tversky A, 'Prospect theory: An analysis of decision under risk', 47(2) *Econometrica*, 1979, 47.
[48] Gächter S, Orzen H., Renner E and Starmer C, 'Are experimental economists prone to framing effects? A natural field experiment', *Journal of Economic Behaviour & Organization*, 2009, 70.
[49] https://fs.blog/2017/11/hammurabis-code/ on 7 July 2018.
[50] https://fs.blog/2017/11/hammurabis-code/ on 7 July 2018.

stating that the banking sector may perform better if in place of rewarding institutions with bonuses we ought to penalise bankers for threatening public well-being; this would foster the creation of wider margins of safety and avert a greater number of banking disasters.[51]

Negative incentives necessitate the creation of penalties and consequences that are commensurate to the failures and crimes committed. The question now is whether such penalties should take a mandatory or voluntary form. Mandatory penalties would be legal or regulatory while voluntary penalties would be self-regulatory. This study opines that if these incentives are to be effective, they must have the force of the law backing them as this will be the surest way to guarantee that the impact is significant enough to invite risk aversion and encourage better banking practices.

1.7.7. The Current Place of the Law in Corporate Governance

The main laws that would come into play in remedying ills of corporate governance would be: The Companies Act, The Capital Markets Act, the Nairobi Securities Exchange (NSE) Rules and the Penal Code. The system of courts in Kenya have been given the mandate to hear and determine any contravention of sections that are found in the above Acts. The strength of the legal regime would be a large factor in determining the effectiveness of any penalties imposed under the law; it is thus necessary for the efficacy of the legal regime that the means of enforcement be in a position to dispense justice in a timely manner.

However, Ndlovu points out that courts are the last recourse sought by shareholders when issues of corporate governance arise.[52] This may be attributed to the lack of confidence in the judicial system when handling matters of this nature. One of the greatest impediments with regards to the setting up of effective legislation is the outdated nature of the Companies Act.[53] A review of the laws as well as regard to their enforcement through legal channels is necessary if the legal system is to be utilised as the bastion of negative incentive for

---

[51] https://fs.blog/2017/11/hammurabis-code/ on 7 July 2018.

[52] Ndlovu M, Bhiri T, Mutambanadzo T, and Hlahla B, 'A comparative analysis of the corporate governance practices in multinational and domestic banks in Zimbabwe', 4(5) *Journal of Emerging Trends in Economics and Management Sciences*, 2013, 473-480.

[53] Atieno Y, (2009). 'Corporate governance problems facing Kenyan parastatals: A case study of the sugar industry', Bucerius Law School, 2009 - http://www.gbv.de/dms/buls/631006060.pdf on 9 July 2018.

banks. The success of such an endeavour is as well heavily dependent on courts having the requisite resources to handle the cases as well as a sufficient understanding of the legal rules in the banking sector so as to enforce the law. These qualities are lacking in the judicial sector of our country as it presently stands.

1.8. Justification

The 21st century has seen the need to give souls to corporations, contrary to the standpoint extolled by Sir Edward Cooke.[54] This is in large part owed to the increased role of corporations and banks in the modern economy. A failure to effectively regulate and enforce corporate governance rules could precipitate market failure resulting in large losses to the economy. As can already be seen from the failure of Chase Bank, Imperial Bank and Dubai, Bank failures in corporate governance can be credited to the downfall of even strong institutions.[55] This study proposes that the self-regulatory mechanism of corporate governance currently employed lacks the power to ensure that banks and corporations comply. This has seen the skirting of these rules with impunity and in the process placing depositors in precarious positions when funds are lost. This study opines that the best recourse to this state of affairs is to replace the current use of positive-incentives in favour of negative-incentives. These negative incentives would assume the form of the imposition of legal penalties in cases of failure to comply with the set-out rules of corporate governance. This hypothesis is backed by the theory of loss aversion that provides that people tend to put in more effort to avoid losses than they do to amass gains.

1.9. Chapter Breakdown

This proposal shall serve as the introductory chapter to the thesis as it outlines the background to the research problem, the research problem, the hypothesis, the literature review, the conceptual framework and the approach and methodology. Chapters 2, 3 and 4 will seek to answer the 3 research questions listed above. Chapter 2 will comprehensively analyse the existing corporate governance regulatory regime in Kenya in order to

---

[54] *Case of Sutton's hospital* (1612), United Kingdom Court of Exchequer.
[55] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',14.

demonstrate that it takes a narrow self-regulatory approach. Chapter 3 will discuss theories of corporate governance so as to give perspectives on the best regulatory approach to corporate governance. Chapter 4 will look into international best practice and to do so it will undertake a comparative study of the UK, the US and Kenya to find the best regulatory approach to corporate governance.

CHAPTER TWO

Corporate Governance and the State

2.1.Introduction

From the foregoing discussion in Chapter One, we can see that the law governing corporate governance in Kenya has its limits. This evinced by the 'comply or explain' framework, a mechanism that combines voluntary compliance with corporate governance codes and a legal obligation to declare compliance with or explain deviations from a code, together with the rules of corporate governance in the Code of Corporate Governance for Issuers of Securities to the Public 2016 issued by the Capital Markets Authority failing to forestall the collapse of banking institutions such as Dubai Bank, Imperial Bank and Chase Bank. The failures of these banks are in my view directly attributable to the limits of the law in corporate governance. Corporate governance has not had its limits solely in Kenya but throughout its development globally. For this reason, this chapter presents the historical development of corporate governance to illustrate these limitations and the resultant efforts to counter these limitations in the likes of the Cadbury Report, Greenburg Report and the Hampel Report. The historical development of corporate governance will be covered in the first section of this chapter.

The second section of this chapter will then address the development of corporate governance in Kenya as an analysis of the corporate governance regime in the banking sector and its failings and ought to begin with a historical perspective. This section will attempt to give the background of corporate governance in Kenya and its gradual adoption in the banking sector; it will further attempt to delve into the nuanced changes that have been implemented over time to address rising concerns emerging in the market. It will also highlight how corporate governance in Kenya basically adopted the UK corporate governance regime as a result of the colonial past.

The third section of this chapter will analyse the efficacy of the current corporate governance regime in its implementation while highlighting some of its successes as well as failures. The penultimate section of this chapter will analyse the collapse of Chase Bank, Imperial Bank and Dubai Bank in an attempt to look at the practical implications

of an ineffective corporate governance framework in the banking sector. The conclusion will show the link between bank failure and poor corporate governance.

2.2. The Development of Corporate Governance

Corporate governance has been an issue since the 1600's when Queen Elizabeth I granted the first royal charter to the East Indian Company.[56] The basic issues of power and accountability for use of power as well as the governance structures of the company are not too different from what we have today.[57] On the governance structure of managers and owners, Adam Smith, in the 18th Century pointed out that the directors of corporations being managers of other people's money rather than their own, cannot be expected to watch over it with the same anxious vigilance as if it were their own.[58] Today corporate governance is still concerned with the same issue of bringing the interests of owners and managers into line.[59]

In the UK, corporate governance became a major issue in the period between the 1980s and 1990s that witnessed the collapse of a number of institutions, which included the Ferranti International PLC, Colorol Group, Pollypeck International PLC, Bank of Credit and Commerce International (BCCI) and Maxwell Communication Corporation courtesy of the lack of a strong corporate governance framework.[60] This led to the British government appointing several committees to investigate corporate governance and the reports of these committees have had a tremendous impact on the development of corporate governance worldwide.[61] These reports were translated into new laws and

---

[56] Akwasi R, 'Corporate Governance and Financial Perfomance: Evidence from the Ghanian Banking Sector' PHD Thesis, University of Bradford, 16.

[57] Akwasi R, 'Corporate Governance and Financial Perfomance: Evidence from the Ghanian Banking Sector', 16.

[58] Malin C, *Corporate Governance,* 19.

[59] Abor J and Biekpe N , 'Corporate Governance and The Small and Medium Enterprise Sector: Theory and Implications. 7(2) *Corporate Governance: The International Journal of Business in Society,* 2007.

[60] University of Cambridge, Judge Business School, the Cadbury Report .http://cadbury.cjbs.archios.info/report on 29 August 2018 on 29 August 2018.

[61] Akwasi R, 'Corporate Governance and Financial Perfomance: Evidence from the Ghanian Banking Sector', 16.

regulations showing the limitations of the existing corporate governance mechanisms.[62] The committees and their reports are discussed below.

2.3. The Cadbury Code

The Cadbury Code marked the beginnings of codified corporate governance. The drawing of the code itself was at the behest of the London Stock Exchange after the failure of a number of banking institutions in the 1980's which shook the public's confidence in financial reporting as well as the ability of external auditors to provide assurance on the financial conditions of the companies they were tasked to report on.[63] It was on the foundation of these concerns that a committee was established under the leadership of Sir Adrian Cadbury with the aim of looking into allegations that financial reporting by companies was plagued by the malaise of 'window dressing'.[64] The committee, however, broadened its scope and attempted to set out in writing a code of best practice that was to inform the expected standards of financial reporting and auditing as well as the attendant responsibilities of all those mandated to ensure that those standards were met. This was eventually reflected in a Code of Best Practice, which may be heralded as the first attempt to codify already recognised practices and render them universally applicable as well as offer added incentive for companies to adhere to them.[65]

In an attempt to preserve the independence of the board of directors the code was presented to companies as being voluntary but with the caveat that companies should explain in their annual reports the extent of their compliance as well as any reasons for non-compliance.[66] What really created the impetus for companies to adopt the rules was two-fold: firstly, in line with the recommendations set out in the Cadbury Code, the London Stock Exchange required the presentation of a certificate of compliance or non-compliance the result of which would determine company listing on the stock exchange;

---

[62] Akwasi R, 'Corporate Governance and Financial Perfomance: Evidence from the Ghanian Banking Sector', 16.

[63] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 2.1.
[64] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 2.1.
[65] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 1.7.
[66] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 3.7.

secondly, investors sponsoring and advising listed companies put pressure on them to adopt the principles as set out.

The Cadbury Report centred on two main aspects: the provisions guiding the board of directors and the accounts of the company. The code was faced with the dilemma of determining whether to allocate more rights to the shareholders as opposed to the board of directors. It however provided that it would be inappropriate for the shareholders to usurp powers from the directors and maintained that the directors should retain their essential powers.[67] However, as a means to protect the rights of the shareholders, the code required accountability from the directors to the shareholders on decisions made.[68] This was intended to curb to an extent the previously arbitrary and at times tyrannical rule of the directors over company affairs.

One of the drawbacks carried forward from family-owned companies was the concentration of power in the hands of a few individuals usually in the form of the CEO or the managing director. To cure this ill, it was necessary that the report addresses the issue of the exercise of control by the company. In this spirit, the code set out that the control of the company should be exercised collectively by the entire board and not dominated by a few individuals.[69] The code further recommended that there be a clear division between the decisions to be made by the executive management and those that should be left to the board. The rationale of this was that in the absence of such a line, executive management would usurp the powers of the board of directors. Further, in the spirit of limiting powers, the code included a strong recommendation that there exists a clear demarcation between the role of the chairperson and the CEO with the responsibilities of each clearly defined.[70] However, in the event this was not the case, the code recommended that there exists a powerful independent counterbalance on the board to aid in diluting the power.[71]

---

[67] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 3.4.
[68] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 3.4.
[69] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 4.1.
[70] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 4.9.
[71] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 4.9.

The Code further addressed the question of the company accounts. On this issue it put forth the suggestion that companies should have an audit committee. The purpose of this committee would be to provide a forum for the discussion of audit issues as well as to review interim and annual financial statements before their submission to the board.[72] The code initially saw this as an opportunity for the creation of an intermediary between the board and the external auditors as opposed to having to deal with them directly as had been previously. Interestingly enough, one of the recommendations of the code that had to be significantly watered down due to the hostility it generated was that the directors should report to the shareholders the entire system of internal control.[73] This was vehemently opposed and was finally included in its diminutive: that the directors would only report on internal financial controls.[74] The Cadbury Report while making strides in addressing the major issues in corporate governance still left quite a number of areas with unresolved issues. This may have informed the Greenbury Report of 1995 that followed.

2.4. The Greenbury Report

The Greenbury Report that was to compliment the Cadbury Report was as a result of public outrage against the remuneration of company directors. It had been the norm for directors to award themselves large sums of money at their discretion. This problem was particularly endemic following the privatisation of public companies that further highlighted the benefits enjoyed by directors in stark contrast to the quality of services provided to the public. Further, it was noted, to the chagrin of the populace that there seemed to exist no link between the directors' remuneration and the performance of the company. There was thus no incentive for the directors to improve the companies' standing as they were well compensated regardless of performance. It was against this background that Sir Richard Greenbury became the chairman of the committee that was constituted to look into the issue of directors' remuneration and come up with viable proposals.[75] In contrast to the Cadbury Report, which was largely well received, the

---

[72] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 4.35.
[73] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 6.6.
[74] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, para 6.8.
[75] Report of the Committee on Corporate Governance, July 1995,

Greenbury Report received mixed reviews, since the predominant perception was that it missed the mark in addressing the key issues.

The report spoke to aspects of remuneration and how companies could skilfully address these potential minefields. The report begun by recommending that remuneration of executive directors should be determined by non-executive directors to address conflict of interest.[76] The report in attempting to come up with remuneration policies while at the same time remaining politically correct by not stepping on anyone's toes, set a number of well-meaning principles that lost all efficacy in their implementation owing to their vagueness. Some of the provisions stated that directors' remuneration should not be excessive, that there be a direct link between shareholder interests and directors' interests, share amounts to directors should not be offered at a discount among other considerations.[77] The report further suggested that there be full disclosure provided for directors' remuneration. All this information, it was recommended, should be set out in detail in an annual report.[78]

2.5. The Hampel Report

The Hampel Report was compiled in 1998 and was meant to progress the work begun by the other two committees. It can perhaps best be credited with the recommendation that the principles set out in the preceding reports should be codified into a single document, this became the 1998 Combined Code.[79] Further, the Hampel Report reiterated the use of principles as opposed to rules with the rationale being that what would work would to a large extent depend on the situation. Therefore, each situation had to be appraised in line with its uniqueness in trying to determine what should be applicable. The Hampel Report further attempted to give a positive dimension to the principles it recommended in a deviation from the two previous reports that primarily focused on deterrence. The Hampel Report essentially echoed what had already been stated in the Cadbury and Greenbury Reports.

---

[76] Report of the Committee on Corporate Governance, January 1998, para 4.8 and 4.11.
[77] Report of the Committee on Corporate Governance, January 1998, para 6.5 and 6.7.
[78] Report of the Committee on Corporate Governance, January 1998, para 5.8 and 5.12.
[79] Report of the Committee on Corporate Governance, January 1998.

2.6. The 1998 Combined Report

The Combined Report brought together and unified the recommendations of the Cadbury, Greenbury and the Hampel Reports. The code was divided into two sections with the first setting out principles that dealt with companies and the second proposing a code of practice for institutional investors.[80] The stock exchange in an attempt to inspire compliance with the rules has required companies to provide two documents the first stating how it has applied the rules set out in section one of the code and the second whether it has complied with the rules set out and if so during which period of time and which specific principles. The Combined Report can perhaps be credited best for cementing the 'comply or explain' approach to corporate governance, which is prevalent today.

2.7. Subsequent Reports

While the reports identified above set the foundation of corporate governance in the UK, the work was far from over and subsequent reports were commissioned and added to the body of recommendations. The Turnbull Report of 1999 followed the combined report and its main aim was to make directors responsible for risk management in the interest of protecting the interests of the shareholders while remaining conscious of how much risk they could reasonably handle.[81] Following this was the Directors' Remuneration Report Regulations of 2002 that necessitated the preparation of annual remuneration reports that would prescribe remuneration policy as well as provide disclosure on directors' remuneration. The Higgs Report was subsequently released in 2002 with the aim of making non-executive directors more effective.[82] It was closely followed by the Smith Report of 2003, which was intended to give companies guidelines on how to make arrangements for their audit committees.[83]

---

[80] http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 268, on 29 August 2018.

[81] http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 270, on 29 August 2018.

[82] http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 271, on 29 August 2018.

[83] http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 272, on 29 August 2018.

The 2003 Combined Code may perhaps illustrate the crown in the corporate governance regime. The revised code included the recommendations from the reports that superseded the Hampel Report. Although the code is longer than the 1998 version, the principles remain more-or-less the same number in line with the belief that the principles should not be weighed down by too many prescriptions.[84] The Combined Code shall be reviewed regularly to ensure it addresses the problems of the times, its most recent revision that heralded some minor changes was carried out in 2008.[85]

As can be gleaned from the discussion above, the UK made incremental adjustments to its codes of corporate governance while taking into account the emerging issues that needed to be addressed and the environment in which they were operating within. It is in this vein that the setting of various committees has occurred to look into the problematic areas and suggest solutions. These solutions were tailored to the needs of the market as it then stood.

2.8. The Development of Corporate Governance in Kenya

This section will illustrate the direct transplantation of English Laws in Kenya, as it was a British colony. It will also aim to discuss, in efforts to synthesis the limits of the law, the Kenyan banking sector. The structure and approach of corporate governance in Kenya has largely been influenced by the United Kingdom (UK) mainly due its past as a former British colony. The formal adoption of corporate governance in Kenya has thus mirrored the situation in the UK. Since independence, the changes in the banking sector largely mirror the country's political and economic transformation from a colony to an independent nation.[86] To understand clearly the direct transplantation of British laws we need to look at the colonial origins first.

---

[84] http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 273, on 29 August 2018.

[85] http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 273, on 29 August 2018.

[86] S Johnson and Upadhaya R, 'Transformation of Kenya's Banking Sector 2000-2012' in Heyer and M Kings, *Kenya's Financial Transformation in the 21st Century,* Financial Sector Deepening Kenya, Nairobi, 2015, 17.

The origins of commercial banking in Kenya lie within the start of the colonial period when Kenya became a British Protectorate in 1895,[87] after which the first two British banks were established; the National Bank of India in 1896 and the Standard Bank of South Africa in 1910. Commercial banking went on to be relatively well established in the colonial period, although it should be noted that banks showed little interest in the indigenous African population.[88]

It was not until the 1950's that other banks began to be established in Kenya. It is also important to note that there was no central bank but in its stead was the East African Currency Board, which had very limited functions.[89] These banks, most of them foreign owned, are documented as extremely conservative in lending out credit as well as establishing a reputation as 'safe banks'.[90] In 1963, at independence, there were nine banks operating in Kenya and in 1966, the CBK was established to regulate banks.[91]

Primary evidence of the direct transplantation of British laws can be seen in the Companies Act (Chapter 486, Laws of Kenya) which was adopted in almost its entirety from England's Companies Act (1948) upon attainment of independence.[92] Directors' duties in Kenya at independence were also governed by common law principles.

Post-independence, in the 1960's Kenya experienced massive economic growth and the government felt that the banks were adjusting too slowly and therefore established two new banks—Cooperative Bank of Kenya and National Bank of Kenya in 1968.[93] The 1970s saw the growth of African owned banks and financial institutions including one local private bank and nine local Non-Bank Financial Intermediaries (NBFI's).[94] These financial institutions were mostly free from regulatory controls.[95] In the 1980's the

---

[87] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',19.
[88] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',19.
[89] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',21.
[90] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',21.
[91] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',21.
[92] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 2.
[93] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',25.
[94] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',25.
[95] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',24.

number of NBFI's would grow from twenty in 1980 to fifty three in 1990 while banks grew from seventeen to twenty four.[96]

This rapid growth has been attributed to political factors such as interference by prominent politicians in the award of licenses and securing of public sector deposits as well as regulatory factors such as very low regulatory barriers.[97] All these contributed to the weakening of the banking systems leading to a number of collapses. The poor regulation led to the inevitable fall of 12 banks between 1984 and 1989 and by 1998 six more banks had fallen, while 1993 alone saw the fall of 15 NBFI's. [98]

There are a number of lessons that may be drawn from the failures of banks that in the 1980's, maladies that seem to have crossed over to the 21st Century in the form of the failures of Chase Bank, Imperial Bank and Dubai Bank. The common thread we see is that directors have since time immemorial treated banks and financial institutions as their personal hedge funds with little to no regard for sound governance principles or shareholder interests. This trend has been reinforced by the fact that the penalties for these actions amount to a slap on the wrist for the guilty parties. There lacks a corporate governance ethic that mandates directors to place stakeholder interests above their own which has led to the abuse of directors' powers to the detriment of depositors. We will see this culture perpetuated in the collapse of Chase Bank, Imperial Bank and Dubai Bank.

2.9. The Law Governing Corporate Governance in Kenya

A system of governance that is based on principles will need to be imbued with two key characteristics if it is to be effective: a robust legislative framework or alternatively ethical players. It has been observed that in adopting the UK corporate governance scheme, as it is to our own landscape, without alteration is akin to uprooting an oak tree from British soil and transplanting it on our own. The following section will attempt to explore the laws currently governing corporate governance in the country with emphasis on those particularly concerned with the financial sector. As Musikali rightly observed, a strong

---

[96] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',24.
[97] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',26.
[98] S Johnson *et al,* 'Transformation of Kenya's Banking Sector 2000-2012',28.

legal framework is a necessity in guarding against self-advancing ploys of those mandated to run our institutions.[99]

On the face of it, Kenya seems primed to perfectly execute a stable corporate governance regime. It has a code of corporate governance in the form of the Code of Corporate Governance Practices for Issuers of Securities to the Public 2015 and a regulatory body in the form of the CMA. Kenya, it seems, parallels more developed countries in its corporate governance framework. It is against this backdrop that we must ask why then our institutions are prone to poor corporate governance. Musikali opines that this is a direct result of mirroring the codes while not reinforcing them through the promulgation of appropriate legislation.[100]

There are various laws governing corporate governance in Kenya, these include the Constitution of Kenya, the Companies Act, the Capital Markets Act, the Nairobi Securities Exchange Rules, the Banking Act, the Prudential Guidelines and the Penal Code most of which will feature in our discussion on corporate governance in Kenya. It is important in order to understand the succeeding section on the analysis of the collapse of Chase Bank, Imperial Bank and Bank of Dubai to grasp the laws that were in place at the material time. This will be followed by a short analysis of the laws as they have been amended in light of recent scandals and whether this piece meal approach will be sufficient to address the issues of concern.

The Companies Act (Chapter 486, Laws of Kenya) can perhaps be cited as a catalyst in the collapse of the three banks in quick succession. It was adopted from the UK after Kenya gained independence.[101] As can be deduced from the analysis of the history of the corporate governance regime in the UK, it is clear that it was premised on three key ideals: self-regulation, director's duties and accounting considerations. This is the same basis reflected in the common law of companies. In the case of directors, it focuses on the duty of care and skill and the duty of loyalty. The duty of care and skill is the courts attempt to ensure that the know-how that the directors have is dedicated to realizing the company's

[99] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 1.
[100] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 2.
[101] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 2.

objectives as opposed to advancing the directors' own enterprises.[102] The duty of loyalty requires of the directors' that they act in good faith, that is to say that they keep in mind the benefits to their companies and not their collateral advantage. Another aspect of the duty of loyalty encompasses the avoidance of conflict of interest, this translates to a caveat that the director not have a personal interest in the business or transactions that the company is a part of.[103] The execution of these considerations is firmly grounded in the existence of robust laws, where these are weak, it is extremely difficult for them to be effective.

The now-repealed Companies Act aimed at providing the guide that would engender adherence to these principles, however, as circumstances would show, the intended result was not the ultimate outcome. There are certain sections worth highlighting that created a window through which fraud and the mismanagement of companies were perpetuated. One such provision was Section 188 of the repealed Companies Act. This section provided a window for bankrupt persons to act as directors of companies as long as they obtained leave of the court.[104] Just on the face of this we can see the loophole that would allow someone who has been declared bankrupt to take advantage of the law to access credit by setting up a limited liability company. It was this same window in the law that allowed the execution of the Goldenberg Scandal and the Anglo-leasing scandal in which companies were set and used to appropriate funds under the guise of dealing with government.[105]

Section 189 of the now-repealed Companies' Act also created room for mischief. The section as then worded provided that directors who had been found guilty of fraudulent trading would be barred from being appointed as directors for a period not exceeding five years.[106] What this translates to is essentially a cooling off period for those who have been involved in fraud as they could take up other positions as directors once they had served their court-dictated time. It is this legislative benevolence that enabled directors who had been prime movers in the pilfering of companies to continue to serve as directors in other

---

[102] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 2.
[103] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 2.
[104] Section 188, *Companies Act* (Cap 486).
[105] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 2.
[106] Section 189, *Companies Act* (Cap 486).

companies. This was the script that played out for the individuals who can be credited with the insolvency of companies such as Kenya National Assurance Company (KNAC) and Kenya Posts and Telecommunications Corporation (KPTC); persons who were prosecuted went on to take up directorships in other companies.[107]

One further illustration in the Companies Act as it existed at the time can be found in Section 402(1) of the repealed Act that provided that where an officer was culpable for breach of trust or negligence, he could be held liable or excused if it was shown that he acted honestly and reasonably.[108] This position is reinforced in *Flagship Carriers Ltd v Imperial Bank* where the court held that directors are only required to show a degree of skill and knowledge as it can be reasonably expected from a person with similar knowledge and skill. This effectively meant that directors had a shield from errors of judgement that they made in business transactions but more than that it gave wide latitude for such errors to be made and condoned without sufficient disincentive to militate against undesirable conduct.

It is my view that these ineffective provisions of the Act played a major role in providing fertile ground for the collapse of the 33 banks in the 80's and as well as the recent failures of Chase Bank, Imperial Bank and the Bank of Dubai. The Penal Code could be viewed as a further catalyst in not having appropriate or decisive provisions for dealing with corporate governance breaches. Section 329 of the Code provides for the penalty of imprisonment for a period of seven years for directors who knowingly give false statements with the intention to defraud or deceive the corporation.[109] However, in the tandem with the preceding highlighted legislation, there is a loophole that emasculates this provision in its current form: this is informed by the fact that the institutional rights belong to the company and not to its members, hence only the corporate entity can seek redress.[110] Thus, minority shareholders were unable to institute a suit for a wrongful action by the company unless it is commenced by an aggrieved individual.[111] The Penal Code,

---

[107] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 3.
[108] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 3.
[109] Section 329, *Penal Code* (Cap 63).
[110] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 4.
[111] Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 4.

to the extent that its provisions do not provide a deterrent on the directors to comply, fails as an effective enforcement mechanism.

2.10. Subsequent Review of the Laws

With the need to review the legislation pertaining to corporate governance necessitated by the collapse of a significant number of institutions, with specific emphasis on banks, laws have evolved over the years in an attempt to cure the inherent shortcomings. The most recent of these gave impetus to the current Companies Act of 2015. However, even before this, there were incremental changes made to the Act over the years as necessitated by the ever-changing circumstances.

The Capital Markets Act is one of the key legislations dealing with the corporate governance regime in Kenya and provides for the creation of the CMA.[112] The CMA is meant to ensure that there exists a conducive environment for long-term investment via the regulation and supervision of the securities market. This is done inter alia by the imposition of penalties for breach of directives given. A case in point is the fine of Ksh. 7,000,000 meted out on Faida Investment Bank for overdrawing clients' accounts coupled with failure to render accurate accounts. Centum Investment was fined Ksh 50,000 for failing to issue a profit warning when its earnings fell by over 25%.[113]

In recent times, the CMA has signalled its intent at addressing corporate malfeasance by initiating enforcement actions against high profile individuals including the KenolKobil CEO, David Ohana, stock market trader Aly-Khan Sachu and Kestrel Capital executive director Andre DeSimone for insider trading.[114]

The CMA has facilitated the release of the Code of Corporate Governance Practices for Issuers of Securities to the Public 2015 (Code 2015) replacing the Codes of Corporate Governance Practices for Public Listed Companies 2002 (Code 2002). The amendment of the code was in an effort to move away from simply suggesting compliance to enforcement. This is in contrast to the 2002 Code that allowed greater flexibility in a bid

---

[112] Section 5, *Capital Markets Act* (Cap 485A).

[113] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, University of Nairobi, Nairobi, 2017, 26.

[114] https://www.businessdailyafrica.com/markets/capital/Kenol-boss--CMA-in-deal-on-insider-trading-probe/4259442-4993922-y89f80/index.html

to provide room for companies to self-regulate. The 2015 code tightens the reigns and now requires companies to declare non-compliance as well as indicating remedial steps towards compliance. Minimum standards of compliance that all listed companies are expected to meet are also set out.[115]

The 2015 Code addresses various issues of corporate governance including provisions pertaining to the board of director's, shareholder rights and the accounting function of companies.[116] The board of directors is considered the nucleus of the company and the various facets of it are addressed under Chapter 2 of the Code. The Code requires that the appointment of candidates to the board of directors be transparent. One of the conditions through which this is guaranteed is the requirement that such candidates declare a conflict of interest. In addition to this, the Code further requires that the board comprise of both executive and non-executive directors with an emphasis on the diversity needed to effectively oversight the company. The 2015 Code also encourages the separation of the role of the Chairman and the CEO by stating that the chairman ought to be a non-executive director and not the CEO. Lastly, it is important to highlight that Code requires that an annual audit be carried out by a professional accredited by ICPAK and the results made public to engender accountability and transparency.

The Code goes further by delineating the rights of shareholders and stakeholders under Chapter Three.[117] The shareholders are provided with the right to information, the right to vote and the right to participation as some of the core rights. In the same spirit, it is recommended that the shareholders be treated equitably. Stakeholders on the other hand are provided for under Section Four with the provision that the board of directors should mould their management on a stakeholder approach, but this is only to the extent that the company's interests take precedence.[118]

---

[115] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 26.
[116] *Code of Corporate Governance Practices for the Issuers of Securities to the Public 2015* (the 2015 Code).
[117] Chapter 3, *Code of Corporate Governance Practices for the Issuers of Securities to the Public 2015* (the 2015 Code).
[118] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 29.

The Companies Act, (2015) is one of the key legislative documents that pertain to corporate governance. Some of the ills we identified in the preceding section sought to be cured by the enactment of this Act. The Act replaced the Companies Act (Chapter 486, Laws of Kenya) and borrows heavily from the Companies Act 2006 of the United Kingdom but modified to suit the Kenyan market. One of the key ways in which the Act differs from the repealed Act is the codification of directors' duties. The new Act now makes it possible for directors to be held personally liable for breach of their duties. It also includes a provision for the disqualification of a director to act in that capacity if they are convicted of an offence or found unfit to act.[119]

The Act additionally attempts to give more power to shareholders. It does this by affording them a better opportunity to participate in decision-making. They can now approve fixed-term contracts for directors as well as approve certain transactions.[120] The act further tries to align itself with the principles of the rule of law by requiring that director's act within their powers as directors while serving the best interests of the company. As a way to reinforce this, the directors are required to divorce themselves from any conflicts of interests as well as refrain from accepting gifts from third parties.[121] The rationale for this is to reduce chances of the directors' loyalty to the company being compromised. The Act, though it has attempted to make significant strides in correcting previous ills is not without its own set of limitations.

The Act in so far as it makes strides in codifying the duties of directors fails in the sense that the duties set out are somewhat vague. One such illustration is the requirement that a director declare any conflict of interest. However, the Act provides an exception to this rule in that the other directors can authorise the director concerned to act as such regardless of the conflict. Further, the Act provides that it is not necessary for the director to declare an interest if the other directors are already aware of it. This has the potential

[119] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 32.
[120] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 33.
[121] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 33.

to leave the door open for the directors to exploit the shareholders' interests.[122] In the same breath, the act fails to place a timeline within which the conflict of interest should be declared. Further to this, there is no attendant liability on the directors in making untrue statements or reckless declarations. Consequently, if such statements are relied upon to the detriment of the shareholders, it would not be possible to hold the directors liable.[123] It is also not required under the Act for a director who has declared an interest that results in profit for the gains to be accounted to the company which makes it possible for directors to benefit from transactions outside the knowledge of the company.

Some of its other shortcomings include the fact that the Act while recognising the need to ensure high accounting standards fails to streamline the accounting standards of companies.[124] A move of this kind would make fraud a lot easier to detect. It would also make it easier for shareholders to determine if the company directors were discharging their duties effectively. The Act also requires that companies lodge a directors' remuneration report every financial year with penalties levied for the failure to do so.[125] This provision fails to designate the contents of the report or whether it will be subject to audit.[126] The Act also does not require the companies to have in place a policy dealing with directors' remuneration. This leaves room for abuse. It is these loopholes that contribute to the reduced efficiency of the corporate governance framework and that this study is attempting to highlight and address.

We must acknowledge the fact that there has been an attempt to address various shortcomings in the Act. Attempts have been made to deal with some of the anomalies that are evident. These include the Companies Amendment Act (2017) and the Companies (General) Amendment Regulations (2017). The Companies Amendment Act (2017) addressed the question of conflict of interest and attempts to close the gaps left in the

---

[122] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 36.
[123] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 36
[124] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 41.
[125] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 42.
[126] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 42.

Companies Act, (2015). It bars directors from receiving any gifts from third parties that are related or reflective of their role and duties in the company.[127] It further requires documentation of the director's family in an effort to hold director's liable for their actions if they happen to negatively impact the company. The essential spirit of the amendment is greater transparency, it however fails in that it does not address the question of the role of executive directors and does not offer guidance on a set standard of financial reporting.[128]

The Companies (General) Amendment Regulations (2017) was perhaps envisioned as coming to address some of the questions left unanswered by the Companies Amendment Act. The Amendment addresses the question of financial reporting. It attempts to offer guidelines on the contents of the directors' remuneration report.[129] It further attempts to draw a link between director remuneration and company performance. This is an attempt to create an incentive for the directors to harbour a stake in the good performance of the company.[130] However, the Act fails in that it does not require the company to have a policy on remuneration, further, it sets the penalty for failure to generate the report as a non-consequential fine not steep enough to engender deterrence.[131]

2.11. The Banking Crisis

The Kenyan economy went through financial upheaval with the fall of three banks in what can be considered quick succession. These were Chase Bank, Dubai Bank and Imperial Bank all of which failed around the period between 2014 and 2016. We can attribute some of the changes made to the Companies Act and its subsequent amendments to the lessons drawn from these bank failures. In an attempt to understand the limitations of the law in engendering good corporate governance we shall highlight the circumstances surrounding the failure of these banks.

---

[127] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 44.
[128] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 45.
[129] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 46.
[130] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 47.
[131] Mukoma J, 'A comprehensive review of the corporate governance legislative framework encompassed in the companies act 2015 in Kenya' unpublished, 47.

2.11.1. The Collapse of Imperial Bank

The failure of Imperial Bank continues to unravel as more pieces are added to the jigsaw puzzle, the latest being the allegation touching on the Deputy Chief Justice Hon. Philomena Mwilu.[132] The bank was established back in 1992 as a Finance and Securities Company.[133] It was placed under statutory management in October 2015 courtesy of unsafe business practices and the presence of unsound business conditions.[134]

The Imperial Bank collapse was reportedly orchestrated by its then-Managing Director, who ended up appropriating a total of 38.5 billion shillings from the bank between the period of 2002 and 2015.[135] The unravelling of the theft came to light only after his death in the form of an anonymous series of emails pointing to the fraud that had been perpetuated in the bank under his watch.

How the Managing Director managed to siphon 38.5 billion shillings came down to three things: a blatant disregard for the principles of corporate governance; a concentration of power at the top of the executive pyramid; and lastly, an ability to pull almost everyone involved into the scheme subtly so as to spread liability. This goes a long way in reinforcing the view that to appeal to the morality of the people is not in fact sufficient deterrence. One of the means that he used to advance the fraud was through handwritten notes for funds to be moved from one account to another with neither explanation nor justification.[136] The smoking gun however lay with an account registered as WE Tilley, a fish processing company which had received, by the time the scandal came to light, Kshs. 34,000,000,000.[137]

---

132 https://www.businessdailyafrica.com/news/Sh131m--deals-with-Imperial-Bank/539546-4737290-x0rioa/index.html on 5 September 2018.

133 https://www.businessdailyafrica.com/news/Sh131m--deals-with-Imperial-Bank/539546-4737290-x0rioa/index.html on 5 September 2018.

134 Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 9.

135 Wafula P. 'Inside Imperial Bank grand Heist: Where masterminds sank stolen sh38 Billion' The Standard, 26 Jan 2016, https://www.standardmedia.co.ke/article/2000189374/inside-imperial-bank-grand-heist-where-masterminds-sank-stolen-sh38-billion

136 Wafula P. 'Inside Imperial Bank grand Heist: Where masterminds sank stolen sh38 Billion' The Standard, 26 Jan 2016, https://www.standardmedia.co.ke/article/2000189374/inside-imperial-bank-grand-heist-where-masterminds-sank-stolen-sh38-billion

137 Wafula P. 'Inside Imperial Bank grand Heist: Where masterminds sank stolen sh38 Billion' The Standard, 26 Jan 2016, https://www.standardmedia.co.ke/article/2000189374/inside-imperial-bank-grand-heist-where-masterminds-sank-stolen-sh38-billion

In order not to be caught, it was necessary for the Managing Director to make sure the books balanced. For this purpose, he colluded with James Kaburu who was the CFO at the time to tweak the accounts appropriately.[138] Later, the Managing Director discovered a software that was able to make the accounts look right to the outside world and successfully conceal the money he was siphoning out of the bank. Ultimately, the theft of Imperial Bank is another illustration of the consequences of slack corporate governance requirements. The CEO consolidated his power and ran the bank as a personal fiefdom. He mandated the movement of money without entertaining questions, he facilitated unregulated lending to companies and finally, he signed off on unsecured loans for people in positions of power as a way of winning favours notwithstanding the exposure of and risk of customer deposits.[139]

2.11.2. The Failure of Dubai Bank

Dubai Bank has a long history in the country stretching back to the year 1982 when it was established. As of the December 2013, the Bank's assets stood at Ksh 2.92 billion, it was therefore extremely shocking when barely two years later in August of 2015, the bank was placed under receivership.[140] The reasons for this as put forth by CBK were the deteriorating cash reserve ratio position as well as a failure to honour certain financial obligations such as paying off Ksh. 48 million which it owed to the Bank of Africa Kenya.[141]

The fate of Dubai Bank was sealed by three major circumstances. First, the bank had only three directors on its board when the minimum required was five. The Bank also had a loan portfolio that stood at 4.1 billion, added to this was the fact that it was insolvent to the tune of 1.3 billion.[142] The Bank was also unable to honour customer instructions to complete transactions totalling Sh41 million.

---

[138]Wafula P. 'Inside Imperial Bank grand Heist: Where masterminds sank stolen sh38 Billion' The Standard, 26 Jan 2016, https://www.standardmedia.co.ke/article/2000189374/inside-imperial-bank-grand-heist-where-masterminds-sank-stolen-sh38-billion

[139] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 9.

[140] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 9.

[141] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 9.

[142] https://www.businessdailyafrica.com/corporate/Imperial--Dubai-Bank-collapse-cases-to-remain-in-the-headlines/539550-3504844-h7gpuc/index.html on 5 September 2018.

Dubai Bank found itself in this precarious position in much the same way other banks have. The former Managing Director Nereah Said, who was fired in 2012, touching on irregular transactions that exposed close to Ksh 2 billion in customer deposits. Nereah went further to point out the principal shareholder, Hassan Zubeidi for putting the bank in the position it had found itself in.[143] She stated that Zubeidi was in the habit of offering unsecured loans to friends and in so doing, placed depositor's funds in jeopardy. Ultimately, the bank was declared unsalvageable and went into liquidation—which may be linked directly to a failure in the corporate governance structure to regulate its activities.

2.11.3. The failure of Chase Bank

Chase Bank opened its doors in 1996. It was the product of the rebranding of the United Bank of Kenya which had been placed under receivership in 1995.[144] The Bank seemed to operate smoothly in the more than one decade in which it served depositors and was even honoured as 'Best Company to Work for in Kenya' by Deloitte. However, the bank came tumbling down on April 2016 when CBK placed it under receivership.[145] The action was informed by the banks failure to meet the statutory banking ratios as well as under reporting of insider loans.

The collapse of Chase Bank was an eventuality waiting to happen. The Chairman Mr. Zaffrullah Khan was the main culprit. Mr. Khan ranks as the largest beneficiary in the looting that brought the bank to its knees through the plunder of Ksh. 11 billion which was systematically siphoned from the bank.[146] Khan managed to orchestrate this through the help of managing director, Duncan Kabui. The two siphoned cash to entities they co-owned.[147] Khan also used some of the money to buy real estate and invest in construction companies in Nairobi and abroad which caused the large outflows that Chase Bank

---

143 https://www.nation.co.ke/business/Dubai-Bank-Receivership-Central-Bank/996-2833288-p0q0rf/index.html on 5 September 2018.

144 Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 9.

145 Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',10.

146 https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.

147 https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.

registered in 2012.[148] In order to re-open Chase Bank, CBK seized assets that amounted to 7.9 billion from the pair.[149] Among the assets were a business park in Karen, a three-acre parking lot in Nairobi, some 240 acres of land on Mombasa Road, a three-acre plot next to the German Embassy on Riverside Drive and various high-end properties in Dubai. The question that begs then, is how were the two able to loot so much money? The answer lies in Musharakah, a sharia compliant financial product used by Islamic Banks, which was used to camouflage irregular insider borrowing.[150] The directors awarded themselves 15-year interest free loans under the guise of Musharakah.[151] Legally, the CBK Prudential Guidelines allow banks to lend internally to staff and directors up to a maximum of 25 percent of core capital. Mr. Khan, in flagrant disregard of this provision, lent himself 7.9 billion, which was largely unsecured.[152] Ultimately, the bank advanced 16.6 billon irregularly to various entities, many of which were associated with insiders.[153]

Eventually, the failure of Chase Bank came down to poor corporate governance practices. This can be seen in the fact that it was difficult to demarcate the properties owned by Chase Bank and those owned by Mr. Khan. Secondly, the rampant unregulated insider lending is another indication that the corporate governance practices were overlooked or lax at best. This can be explained by the fact that most of these loans were non-performing as a large number were unsecured and unlikely to be paid back at all.[154]

---

148 https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.

149 https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.

150 https://www.nation.co.ke/business/CBK-seizes-Sh8bn-from-Chase-Bank-directors/996-3181514-oio54hz/index.html on 5 September 2018.

151 https://www.nation.co.ke/business/CBK-seizes-Sh8bn-from-Chase-Bank-directors/996-3181514-oio54hz/index.html on 5 September 2018.

152 https://www.nation.co.ke/news/Rogue-bank-goes-down-with-Sh96b/1056-3150706-q2kfehz/index.html on 5 September 2018.

153 https://www.nation.co.ke/news/Rogue-bank-goes-down-with-Sh96b/1056-3150706-q2kfehz/index.html on 5 September 2018.

154 Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016',12.

2.12. Conclusion

The findings of this chapter show the inextricable link between corporate governance failure and bank failure. The corporate governance structures have proven insufficient by allowing directors to make away with millions. The lesson to be drawn from the flagrant abuse of the confidence of depositors in the above banks is that fraud is omnipresent. As much as we would like to leverage the essential goodness in human nature, we ought to concede that perhaps principle-based approach while idealistic is not realistic. What we should draw from the above is the need to employ stronger enforcement mechanisms to ensure compliance to the code of corporate governance.

CHAPTER THREE

Theoretical Underpinnings of Corporate Governance

3.1. Introduction

This chapter sets out to discuss the various theories underpinning the development of corporate governance and the areas it impacts. An analysis of the theories on corporate governance lays a base for understanding the issue in greater depth. An important caveat issued by Christine Mallin is that due to corporate governance being a global phenomenon it brings about legal, cultural and structural differences thus some theories may be more relevant and appropriate to one country than they are to another.[155]

The theories that affect corporate governance are quite varied and include; Agency, transaction cost economics, stakeholder, stewardship, class hegemony, managerial hegemony, path dependence, resource dependence, institutional, political and network governance. We hope to undertake an analysis of the main theories herein.

3.2. The Agency Dilemma

The agency dilemma is also known as the agency problem or the principal agent problem. The 'principal-agent' problem was first referenced by Ross to refer to the general problem of devising a contract to ensure the agent pursues the principal's goals as efficiently as possible.[156] Ross continues to state that there are two sources to the principal-agent problem; imperfect information and misalignment of goals between agent and principal. For Eisenhardt, agency theory is concerned with resolving two problems that can occur in agency relationships; 1) conflicting desires between the principal and the agent and 2) the difficulty and the high costs involved when the principal tries to verify what the agent is doing.[157]

---

[155] Malin C, *Corporate Governance,* Oxford University Press, 5 ed, Oxford, 2016, 16.

[156] Ross S 'The economic theory of agency: The principal's problem' 53(2) *American Economic Review,* 134-39.

[157] Eisenhardt K, 'Agency Theory: An assessment and Review', 58.

Eisenhardt and Ross were not alone in identifying the problems with the agency relation. As early as the 18th Century, Smith pointed out that the directors of corporations being managers of other people's money rather than their own, cannot be expected to watch over it with the same anxious vigilance as if it were their own.[158]

This problem can be expressed as self- interest or opportunism on the part of the agent.[159] In an agency relationship the principal expects the agent to act and make decisions in the best interests of the shareholder. However this may not always be the case and there are a number of dimensions to this; the agent may not act in the interest of the principal at all, he may act just partially in the interest of the principal, there may also be information asymmetry where the agent has access to more information and thus putting the principal at a disadvantage.[160] The position that agents will always act in their self-interest is one put forward by those who, using the economic model of rationality, assume that rational individuals are self-interested and act only from egoistic or altruistic motives.[161]

The standard response to the position is that the economic model of rationality suggests no such thing. The model assumes that the individuals always make prudent and logical decisions that provide them with the highest amount of personal utility and this happens to reflect the desires that they may have be they egoistic or altruistic.[162] Therefore, agency theory is how individuals manage situations involving goal incongruity between two or more persons notwithstanding that the goals may be selfish or not and that the goals of the other only show up in so far as they affect the goals of the agent thus business ethicists have concluded that agency theory is perfectly harmless.[163]

The second problem highlighted by Eisenhardt is that of agency costs. Agency costs include the costs of structuring, monitoring and bonding a set of contracts among agents with conflicting interests. Agency costs also include the value of output lost because the

---

[158] Malin C, *Corporate Governance,* 19.
[159] Malin C, *Corporate Governance,* 17.
[160] Malin C, *Corporate Governance,* 17.
[161] Heath J, 'The Uses and Abuses of Agency theory' 19 *Business Ethics Quarterly* 4, 2009, 503
[162] Heath J, 'The Uses and Abuses of Agency theory', 500.
[163] Heath J, 'The Uses and Abuses of Agency theory', 500.

costs of full enforcement of contracts exceed the benefits.[164] This is better understood if we view our concept of an organisation as a nexus of contracts, written and unwritten, among owners, factors of production and customers.[165] The said contracts specify the rights of each agent in the organisation and the performance criteria for evaluating agents.

3.3. Agency Theory

Agency theory is at the forefront of the development of corporate governance as well as providing the theoretical framework in which corporate governance finds a natural habitat.[166] Agency theory having roots in economic theory can be defined as the relationship between the principals, such as shareholders, and agents such as the company executives and managers.[167] Its sheer simplicity in reducing the management of a corporation to just two levels (managers and shareholders) has been deemed a major factor in its prominence.[168]

Agency theory identifies the agency relationship where one party (the principal) delegates work to another party (the agent) and in the context of a corporation the owners (shareholders) are the principals while the agents are the directors.[169] Corporations quoted on the stock exchange (whether the NSE or the London Stock Exchange) are often large and require substantial investment in equity to fund them thus inevitably they would have a large number of investors in the form of shareholders. Shareholders therefore delegate control to what they consider professional managers who take the form of a board of directors. The agency theory in the context of corporations is set in the context of separation of ownership and control. The owners are the shareholders while the directors of the corporations control the corporation.[170]

---

[164] Fama E and Jensen M, 'Separation of Ownership and Control' 26(2) *The Journal of Law and Economics*, 1983, 304.
[165] Fama E and Jensen M, 'Separation of Ownership and Control', 302.
[166] Malin C, *Corporate Governance,* 24.
[167] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance' *Middle Eastern Finance and Economics*, 2009, 89.
[168] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 89.
[169] Malin C, *Corporate Governance,* 16.
[170] Malin C, *Corporate Governance,* 19.

According to Eisenhardt, the key idea in agency theory is that principal agent relationships should reflect the efficient organisation of information and risk bearing costs.[171] The assumptions of this theory can be categorised into human and organisational. The human ones being self-interest, bounded rationality, risk aversion while the organisational category contains; information asymmetry between principal and agent, efficiency as the effectiveness criterion and lastly partial goal conflict among participants.[172]

To understand the various positions put forward, it is important to note that most of agency theory as related to corporations is set in the context of separation of ownership and control. With investors or shareholders being the owners and directors taking control. The development of this relationship has been credited for the industrialisation of countries and separation of markets.[173] The United Kingdom and the United States of America have been praised for their legal systems that fostered strong and good protection for minority shareholders resulting in a more diversified shareholder base.[174]

Unfortunately, the same protections cannot be said to have been provided to many minority shareholders especially in the many countries that use a civil law system.[175] This can be attributed to the rigidity of a civil law system that does not do so well in adapting to the ever-changing corporate landscape.[176] The weaker protection of rights does not do well to attract investors. Rather, it keeps them away.

The problem of self-interest as discussed earlier can be seen to manifest itself quite well in this discussion of separation of ownership and control. A tendency among corporations has been to dilute controlling blocks of shares leading to ownership without power.[177] These powerless owners have had to watch on as directors overpay themselves, scandals unfold and collapses occur. Ultimately, these shareholders have witnessed the loss of their investments.

---

[171] Eisenhardt K, 'Agency Theory: An assessment and Review' 14 *The Academy of Management Review* 1, 1989, 59.
[172] Eisenhardt K, 'Agency Theory: An assessment and Review', 59.
[173] Malin C, *Corporate Governance,* 17.
[174] Malin C, *Corporate Governance,* 17.
[175] Malin C, *Corporate Governance,* 18.
[176] Malin C, *Corporate Governance,* 18.
[177] Malin C, *Corporate Governance,* 18.

Flowing from this, we can say that the calls for shareholders to reclaim their power and act as owners not just holders of shares have been justified if not necessary. If they do this, then they will be able to exercise more direct control over boards hence fostering accountability and improved transparency as embodied in corporate governance codes.[178]

The board of directors is a particularly essential monitoring device to try and ensure that any problems that may be brought about by the principal agent relationship are minimised. Blair in Malin put it succinctly, 'Managers are supposed to be the agents of a corporations 'owners' but managers must be monitored and institutional arrangements must provide some checks and balances to make sure they do not abuse their power.'[179] The institutional arrangement providing the said checks and balances is the board of directors. It is vital that the board and the board chair are independent of the CEO and that incentives are used to bind CEO interests to those of shareholders.[180]

Agency theory is particularly important in this paper as it is regarded by many as an essential tool for analysing and understanding the spate of corporate ethics scandals.[181] Others have taken the completely opposite stance, as is so often with these matters, and gone as far as saying that these scandals would not have occurred had it not been for the widespread teaching of the agency theory in the majority of business schools.[182]

With firms in the banking sector, a focus of this paper, a similar set of agency conflicts arises owing to the interaction of three sets of interest groups; managers, shareholders and creditors. As earlier intimated, shareholders often have conflicts with managers because managers seek quick profits that increase their own wealth, power, reputation and rewards, (what we have termed as the problem of self-interest) while shareholders are more interested in a slow and steady growth over time. Since banks operate under different

[178] Malin C, *Corporate Governance,* 18.
[179] Malin C, *Corporate Governance,* 17.
[180] Malin C, *Corporate Governance,* 21.
[181] Heath J, 'The Uses and Abuses of Agency theory', 03.
[182] Heath J, 'The Uses and Abuses of Agency theory', 503.

statutes, the transaction and borrowing costs increase due to information asymmetry; increased monitoring and limiting managers' powers.[183]

To surmise this paper's discussions of agency theory, according to agency theorists, the purpose of studying the agency theory is to identify points of conflict among the key players and suggest the following mechanisms of corporate governance to reduce it:

1. No duality, that is, one person should not hold the position of CEO and Chairman of the Board. This avoids managerial opportunism and agency loss.
2. Provision of financial incentives to managers: including fixing executive compensation and levels of benefits linked to shareholders' returns.
3. Introduction and inclusion of more independent directors on the board.
4. Direct intervention by shareholders and the threat of firing the underperforming managers (shareholder activism).
5. An active market for corporate control: The threat of a hostile takeover disciplines managerial behavior and induces managers to focus on maximizing shareholder value.

3.4. Stewardship Theory

Stewardship Theory has its roots in psychology and sociology and was first properly defined by Davis, Schoorman and Donaldson. Their definition being, 'a steward protects and maximizes shareholders wealth through firm performance because by so doing, the stewards' utility functions are maximized.'[184] Stewardship Theory stresses not on the perspective of individualism, but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. [185]

---

[183] Hughes J and Mester L, 'Efficiency in Banking: Theory, Practice and Evidence' *Oxford Handbook of Banking*, 2008, 4.
[184] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 90.
[185] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 90.

The theory recognizes the importance of structures that are geared and built towards maximum autonomy and trust in an effort to empower the steward.

Stewardship theory is discussed after agency theory because it draws on the assumptions underlying it. It is also closely related to agency theory in that those who were wary of it introduced it as an alternative to agency.[186] While agency calls for protection of shareholders' interests by separation of incumbency of roles of board and chair, stewardship theory argues that shareholders' interests are maximized by shared incumbency of these roles.[187] This is because stewardship theory aims at creating a situation where power and authority are concentrated in one person. Stewardship theory intends for the CEO's power to be unambiguous and unchallenged with no room for doubt over who has authority over a particular matter.[188] Thus the corporation gets to enjoy the benefits of unity of direction of strong command and control. [189]

Donaldson and Davis conducted research on the entire debate on whether the CEO and the Chair of the board should be separate people. In their research they term it as duality if one person holds the CEO position and is also the chair of the board. Their research had four hypotheses that it was testing. They could be grouped into two categories, hypotheses yielded by agency theory and those yielded by stewardship theory. Interestingly enough, the two sets of hypotheses were diametrically opposed.

The hypotheses yielded by agency theory are; 1) CEO duality leads to lower returns to shareholders and 2) Any observed positive effects of CEO duality are caused by long-term compensation and are spurious.[190]

---

[186] Malin C, *Corporate Governance,* 21.
[187] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns' *Australian Journal of Management,* 1991,49.
[188] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',52.
[189] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',52.
[190] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',52.

The hypotheses yielded by stewardship theory regarding corporate governance; 1) CEO duality leads to higher return to shareholders and 2) the positive effects of CEO duality are not due to the spurious effects of long-term compensation.[191]

Their research presents empirical evidence that the returns to shareholders are improved by combining the roles of the chair and the CEO.[192] Therefore the results fail to support the agency theory and lend support to stewardship theory with regard to CEO governance.

Put succinctly, the stewardship model can be summarized as one where shareholders empower and trust stewards who in turn get both intrinsically and extrinsically motivated to perform in a way that protects and maximizes shareholders wealth.[193] The executive manager, stewardship theory holds, has no problem of executive motivation; he is far from what you would describe as opportunistic and essentially wants to be a good steward of the corporate assets.[194] Because of the trust in stewardship theory there are minimal to no costs involved in monitoring and controlling employees as opposed to the well-documented agency costs.[195]

Donaldson and Davis, albeit proponents of stewardship theory, argue that due to the mixed empirical evidence neither agency theory nor stewardship theory represent a 'golden bullet' for corporate governance.[196] There is also empirical evidence from a study of seven hundred and sixty eight company directors from the United States of America showing that these directors experienced role conflict in having to serve shareholder interests whilst at the same time maintain camaraderie within the board.[197]

---

[191] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',52.
[192] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',62.
[193] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',51.
[194] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 90.
[195] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 90.
[196] Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns',62.
[197] Lawler E and Finegold D, 'CEO Compensation: What Board Members Think', *Marshall School of Business*, 2017.

3.5. Stakeholder Theory

A stakeholder is defined as any group or individual who can affect or is affected by the achievement of the organisation's objectives.[198] A common way of differentiating the various categories of stakeholders is to consider the groups that have classifiable relationships within the same organisations.[199] They include: customers, suppliers and distributors, shareholders and the local community.

The stakeholder theory is hinged on the fact that, unlike the agency theory where the managers 'serve' the stakeholders, the stakeholders in this case all have various responsibilities to serve.[200] These various responsibilities include decision-making and they are mainly based on a network of relationship amongst the stakeholders. It is taken that the stakeholders have various interests in the organisation and that no interest is meant to dominate each other,[201] hence, the importance of the network of relationship. In juxtaposition to the agency theory, it holds and takes into account a wider group rather than just the shareholders.[202]

The 21st century has been characterised by drastic changes in business, which include globalisation, the growth of information technology and the liberalization of states. One of the key changes has been the increased societal awareness of the impact of businesses on communities and nations.[203] This inherently introduces the public trust doctrine in business. Most business crises illustrate two points. The first is that they both evidently depict that managerial actions affect a broad range of people.[204] Second, that the pursuit of corporate objectives can be easily disrupted by the actions of unexpected groups or individuals.[205] The stakeholder theory was therefore developed to conceptualize and solve such problems.

---

[198] Fonataine C, Haarman A and Schmid S, *The stakeholder theory*, 2006, 3.
[199] Fonataine C *et al*, *The stakeholder theory*, 6.
[200] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 89.
[201] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 89.
[202] Malin C, *Corporate governance,* 18.
[203] Freeman E, Harrison J, Wicks A, Parmar B and Colle S, *The stakeholder theory: State of the art,* Cambridge University Press, New York, 2010, 3.
[204] Freeman E et al, *The stakeholder theory: State of the art*, 5-6.
[205] Freeman E et al, *The stakeholder theory: State of the art*, 5-6.

This theory was proposed and developed by Freeman in 1984. It seeks to address and redress three pertinent questions. The first is the problem of value creation and trade. It sought to answer the question of how value is created in a constantly and rapidly changing business world. The second was the problem of the ethics of capitalism. This is because capitalism became the dominant way of determining value and organising trade. Therefore, its effects had to be taken into consideration by the decision makers rather than its effects being determined and felt by society.[206] The third is the problem of restructuring the managerial mind-set. With the dynamic business world, decision makers need to remain relevant and make informed decisions about the businesses in question. Freeman suggests, through the stakeholder theory that a relationship between these decision makers would better manage and deal with these problems that it ought to address.[207] The general idea of the stakeholder theory is therefore a re-definition of organisation.[208]

Freeman recognised that the traditional strategy approach bore no fruit especially in times of economic turbulence. He saw the need for a restructuring of the organisational models in firms. He therefore decided to choose the word 'stakeholder' on the basis of the traditional term stockholder which only took a look at the economic point of view of business while the term stakeholder could be adapted to mean any group that can affect or is affected by the achievement of the organisation's objectives.[209]

It is more of a practical theory because all firms, in this case banks, have to manage the stakeholders to yield positive results. Stakeholders that are treated and managed well reciprocate positively towards the organisation by sharing valuable information, buying more products and services, providing better financial terms and providing tax breaks or other incentives.[210] This decision-making process does not exist in a utopian world. What this means is that, unlike other business theories that rely on purely separating business decisions from ethical decisions, the stakeholder theory integrates the two.[211] Thus, the

---

[206] Freeman E et al, *The stakeholder theory: State of the art*, 5-6.
[207] Freeman E et al, *The stakeholder theory: State of the art,* 5-6.
[208] Fonataine C, *et al, The stakeholder theory,* 3.
[209] Fonataine C, *et al, The stakeholder theory,* 11.
[210] Harrison J, Freeman E and Abreu M, 'Stakeholder theory as an ethical approach to effective management: Applying the theory to multiple contexts' 17 *Review of business management* 55, 2015, 859.
[211] Freeman E, 'The politics of stakeholder theory: Some future directions' 4 *Business Ethics Quarterly* 4, 1994, 401-421.

genesis of the stakeholder theory is the integration thesis and the responsibility principle.[212]

The integration thesis advances the idea that one cannot separate decision-making in business and ethics. The idea was articulated by stating that most business decisions have some ethical content or an implicit ethical view and vice versa.[213] Secondly, the moment we separate ethics from business, we eliminate the responsibility aspect of being held accountable for various managerial decisions. This allows people to get away with as much at the expense of others, creating a pool of opportunists and a corporate governance structure modelled on impunity.[214] The stakeholder theory therefore hinges on these two principles and strives to achieve a situation of business working effectively and at its best. A stakeholder approach emphasizes on the importance of investing in relationships with those who have a stake in the firm. If the networks mentioned earlier are managed properly, the stability of a firm is guaranteed.[215]

So, it does solve the problem of value creation because it can show how businesses can be described through these same decision-making relationships. The problem of managerial mindsets by putting in place proper structures that define stakeholder relationships and intertwine ethics and decision-making in business.

The stakeholder approach is quite different from the shareholder view. According to Williamson, shareholders deserved special consideration over other stakeholders because of 'asset specificity'. Which was mainly because he believed that the shareholder's stake was tied to the success of the firm.[216] Before countering this argument, it is important to be cognizant of the fact that many companies strive to maximise shareholder interest. This means that the shareholders, excluding the stakeholders are the prime recipients of the free cash-flow (profits gained after all the stakeholders and loans have been paid).[217] This in turn evidences the fact that the whole society does not gain maximum benefit, as it

---

[212] Fonataine C, *et al*, *The stakeholder theory*, 9.
[213] Freeman E *et al, The stakeholder theory: State of the art,* 7-8.
[214] Freeman E *et al*, *The stakeholder theory: State of the art*, 8.
[215] Freeman E, 'The stakeholder approach revisited', 2004, 234.
[216] Freeman E, 'The stakeholder approach revisited', 235.
[217] Malin C, *Corporate governance,* 18.

should be. The shareholder approach is based on the Anglo-American model where the board executives are purely based on the shareholder's choice.[218] However, the stakeholder theory is based on the German model where the public and employees have a say and a right to elect their representatives to sit alongside with the directors.[219] Back to Williamson's approach; his argument could be used to also explain stakeholder relationship. All stakeholders have an interest and stakes that are specific[220] thus fulfilling the requirement of 'asset-specificity'.

To further understand the stakeholder theory, it is important to recognise that business is about how customers, suppliers, employees, financiers, communities and managers interact.[221] They all have some interest in the organisation (the 'asset specificity'). For example, employees have their jobs and livelihood at stake, financiers have a financial stake (in form of bonds and so on), customers and suppliers benefit from the products and services and the local community grants the firm rights to build facilities and in turn, benefits from the tax base and economic contributions.[222] No stakeholder's interests are considered over the others. Their interests must be connected. Even when interests conflict, there has to be a way of rethinking the problem to create a multifaceted interest once again.[223]

The purpose of the stakeholder theory was to create methods for different groups to achieve strategic management.[224] Donaldson and Peterson recognised that the stakeholder theory was descriptive, instrumental and normative; Descriptive: Aims to understand how managers deal with stakeholders and how they represent their interests;[225]Instrumental: it studies the organisational consequences and the connection between the practice of the stakeholder management and the achievement of various corporate goals;[226]Normative:

---

[218] Malin C, *Corporate governance,* 18.
[219] Malin C, *Corporate governance,* 18.
[220] Freeman E, 'The stakeholder approach revisited', 235.
[221] Freeman E *et al*, *The stakeholder theory: State of the art*, 24.
[222] Freeman E *et al*, *The stakeholder theory: State of the art,* 24-25.
[223] Freeman E *et al*, *The stakeholder theory: State of the art,* 27.
[224] Fonataine C *et al*, *The stakeholder theory*, 13.
[225] Donaldson T and Preston L, 'The stakeholder theory of corporation: Concepts, evidence and implications' 20 *Academy of Management Review* 1, 1995, 70-71.
[226] Donaldson T and Preston L, 'The stakeholder theory of corporation: Concepts, evidence and implications', 71.

The identification of the moral and philosophical guidelines linked to the activities or the management of corporations.[227]These principles enable and guide actual stakeholders in forming a proper organisational firm model.

However, there is some criticism towards the stakeholder theory. Firstly, some scholars claim that it provides an inadequate explanation of the firm's behaviour within its environment meaning that it does not sufficiently address the dynamics which link the firm to the stakeholders.[228] There has also been an issue towards the Stakeholder Theory suggestion that stakeholder groups can be easily identified as separable entities while in reality it's more complex than that.[229] The final criticism towards stakeholder theory is that it regards the environment as static as it does not address the element of change that occurs over time.[230] Despite this, the stakeholder theory is considered to better equip managers to foster and articulate the shared purpose of the firm.

3.6. Transaction Costs Economic Theory

As mentioned earlier in this chapter, agency theory is the most prominent theory that is applied in corporate governance. However some researchers tend to consider the agency theory inconclusive from the perspective of whether it answers the following questions: (i) whether ownership concentration is related to better firm performance (ii) whether the composition of the board of directors, its size, or the committees in it have any impact on the firm's performance.[231] Conclusively, there have been conflicting opinions on the comprehensibility of the agency theory. Different researchers have different conclusions and beliefs.[232] Basically, the lack of conclusiveness of the agency theory necessitated a shift in the theoretical focus. The agency theory also emphasises the need and importance of the separation of ownership and control. This meant that as firms grew in size, they automatically required an increase in capital, creating a conflict and general issues

---

[227] Donaldson T and Preston L, 'The stakeholder theory of corporation: Concepts, evidence and implications', 71.
[228] Key S, ' Towards a new theory of the firm: a critique of stakeholder theory' 37(4) *Management Decision*, 1999, 317-328.
[229] Key S, ' Towards a new theory of the firm: a critique of stakeholder theory',317-328.
[230] Key S, ' Towards a new theory of the firm: a critique of stakeholder theory',317-328.
[231] Saravia J and Chen J, The theory of corporate governance: A transaction cost economics- firm lifecycle approach, 2008, 1.
[232] Saravia J and Chen J, 'The theory of corporate governance: A transaction cost economics- firm lifecycle approach', 1-2.

surrounding the whole idea of separation and ownership. [233] Thus, leading to the adaptation of a new theory, the Transaction Cost Economics (TCE).[234]

The Transaction Cost Economics theory was first highlighted by Ronald Coase in 1937 and has now expanded to become one of the most influential management theories that addresses not only the scale of the firm but also its internal workings of corporate governance and organisation.[235] It was not until the 1970s/1980s that this theory was gradually developed by Oliver Williamson.

There are two main types of transaction costs; internal ones and external ones.[236] External costs include paid costs of getting information in addition to the opportunity cost of the time that is taken up in searching.[237] It is important to note that when undertaking a transaction, parties must incur several costs (transaction costs). For example, if a transaction is to be governed by a contract, the contract must be drafted, the terms must be negotiated. Such costs are *ex ante* costs. Costs incurred before the transaction takes place, while *ex post* costs are incurred in consummating and safeguarding the deal that was originally struck. The basic notion of transaction cost economic theory is that transactions tend to be placed in a way that maximises the net benefits they provide, including the costs of transactions. Therefore, if a transaction's cost outweighs the benefits of completion, it will not be undertaken at all.

The transaction cost approach regards the transaction as the basic unit of analysis and it requires that all transactions in a firm be put in dimensions and that alternative governance structures be described.[238] At its foundations, the theory is more concerned with organisational efficiency.[239] For example, how a complex transaction should be structured

---

[233] Malin C, *Corporate Governance,* 20.
[234] Saravia J and Chen J, 'The theory of corporate governance: A transaction cost economics- firm lifecycle approach', 2.
[235] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance' *Oxford Research Encyclopaedia of Business and Management,* 2017, 1.
[236] Yousuf A, 'Transaction costs: A conceptual framework' 2 *International Journal of Engineering and Management Sciences* 3, 2017, 133.
[237] Yousuf A, 'Transaction costs: A conceptual framework' 136.
[238] Williamson O, 'The economics of organisation: The transaction cost approach' 87 *The American Journal of Sociology* 3, 1981, 548.
[239] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance', 1.

and governed so as to minimise waste and also the internalisation of the transaction to provide a more efficient approach.[240]

Transaction costs refer to the explicit fees that are associated with it and the implicit fees of monitoring and controlling a transaction.[241] The choice of governance structure by decision makers ought to be holistic and should consider human and environmental factors, also known as the dimensions of transaction costs. Human factors include bounded rationality which comes from the limited capacity of shareholder and managers in a firm to process all the available information and consider every possible outcome associated with a transaction.[242] Bounded rationality, in simple terms, means the lack of enough information.[243] This exposes the parties to some sort of risk such as exploitation. Generally, this increases the transaction costs because the company cannot easily make the right decisions because they lack adequate information about a given relationship or environment. To counter this, the owners or relevant parties must incur some costs in gaining such information.

Another human factor is opportunism. Being perceived as a 'self-interest seeking with guile', principals and agents have different goals with their own self-interest being at the forefront.[244] A firm must therefore use safeguards as a guarantee when signing contracts to be sure that services agreed upon are fulfilled and the supplier will not tend to act in his own best interest.[245]

---

[240] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance', 1.
[241] Htay S and Salman S, 'Transaction cost theory, political theory and resource dependency theory in the light of unconventional aspect' 12 *Journal of Humanities and Social Science* 5, 2013, 90.
[242] Htay S and Salman S, 'Transaction cost theory, political theory and resource dependency theory in the light of unconventional aspect' 91.
[243] Yousuf A, 'Transaction costs: A conceptual framework', 134.
[244] Htay S and Salman S, 'Transaction cost theory, political theory and resource dependency theory in the light of unconventional aspect', 91.
[245] Yousuf A, 'Transaction costs: A conceptual framework', 134.

Environmental factors can be summed up through asset specificity. Asset specificity is the most important dimension of describing transactions. It refers to the degree in which the investments necessary for a transaction are specific and particular to that transaction.[246] It can arise in three ways:

a. Site specificity. When a series of successive stations are located next to each other so as to reduce and economise on transportation and inventory expenses.[247]
b. Physical asset specificity. This is where specialised machines are meant to produce a component.[248]
c. Human asset specificity. These are experience costs. What the individual learns by doing.[249] This skill acquisition should be specific to the employer. The mere deepening of skills that are not relevant to the firm means that the employee is easy to substitute. However, greater valued skills need to be embedded and protected in a protective kind of governance structure.[250]

When assets are unspecified towards a buyer, a supplier can easily sell the output to the market without any difficulties.[251] Buyers can also easily turn to alternative sources. Williamson refers to this as idiosyncratic transactions. However, when a buyer convinces the supplier to invest in a specific or rather when an investment is made, the buyer and seller then start effectively operating in a bilateral relation for a considerable period of time.[252] The buyer is therefore committed to the transaction and the seller cannot look for other alternatives.

---

[246] Marie-Claude B et al, *The beginning of transaction cost economics: The beginning of a new direction,* 1126.
[247] Williamson O, 'The economics of organisation: The transaction cost approach', 555.
[248] Williamson O, 'The economics of organisation: The transaction cost approach', 555.
[249] Williamson O, 'The economics of organisation: The transaction cost approach', 555.
[250] Williamson O, 'The economics of organisation: The transaction cost approach', 563.
[251] Ivarsson T, Knape J and Wang H, *A sustainable approach to transaction cost economics*, 2017, 1.
[252] Williamson O, 'The economics of organisation: The transaction cost approach', 555.

Transactions ultimately have three dimensions: uncertainty, the frequency of which transactions recur and asset specificity.[253] Having discussed asset specificity, we shall now take a look at the other two dimensions as components of the TCE theory.

Uncertainty refers to the risk associated with a transaction.[254] This can arise from both environmental variability and behavioural variability. Environmental uncertainty such as technological uncertainty deals with the difficulty of foreseeing and anticipating changes in the relevant environment.[255] The problem with contracting is that it is quite difficult as well to write complete contracts that envisage these unforeseeable events. In the long run, this might be seen as contractual gaps that may necessitate the need for re-negotiation and adaptation. Contract re-negotiation and adaptation is a costly process and will most definitely increase transaction costs.[256] Behavioural uncertainty is based on opportunism and also encompasses the difficulty in evaluating the behaviour and performance of a transaction partner. It is very difficult to examine who will engage in opportunistic behaviour.

Secondly, frequency refers to the volume of transactions between the two exchange parties.[257] If transactions are not frequent, then the cost of alternative governance structures may not be justified. A larger volume transaction gives rise to the justification for alternative governance structures.[258]

So how then is the transaction cost economics theory relevant to corporate governance? If assets are non-specific, there is no need of having corporate governance structures. This is because there are no complex transactions to be carried out. A simple transaction such as purchasing milk has little uncertainty to it, low asset specificity and no risk, therefore

---

[253] Williamson O, 'The economics of organisation: The transaction cost approach', 555.
[254] Ivarsson T *et al*, *A sustainable approach to transaction cost economics*,14.
[255] Rindfleisch A and Heide J, 'Transaction cost analysis: Past, present and future applications' 61 *Journal of Marketing* 4, 1997,
[256] Williamson O, 'Transaction cost economics: The governance of contractual relations' 22 *Journal of Law and Economics* 2, 1979, 254.
[257] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance', 7.
[258] Martins R, *Transaction cost theory influence in strategy research: A review through a bibliometric study in leading journals,* 2010, 5.

it is a straight forward transaction.[259] Therefore, the TCE theory goes ahead to explain why such simple transactions are organised in a buyer- seller market and provides insight on why complex transaction require complex governance structures.[260] Governance structures can be seen as a way of internalising and making decisions that have not been thought out in the initial contract.[261] The TCE approach ensures that governance decisions are held accountable at every decision-making level to ensure maximisation of benefit and the economisation of costs.[262]

Williamson defines a governance structure as an 'institutional framework which the integrity of a transaction is carried out or a related set of transactions is decided'.[263] Governance is therefore based upon the fact that the decisions made should be in view of ensuring economic transactions. Therefore, if the cost of using the market is too high, other governance structures, such as hierarchical production in a firm, are preferred.[264]

3.7. Resource Dependency Economic Theory

It derives from economics and sociology disciplines concerned with the distribution of power in the firm. This theory views the board of directors as the lynch pin between a company and the resources it needs to use as it seeks to fulfil its objectives.[265] It focuses on the role that directors play in providing and securing essential resources to an organization through its linkages to the external environment.[266] The resources in question being brought to the firm include information, skills and access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy[267]. Generally, there are four categories into which directors may be placed; insiders, business experts, support specialists and those who influence the community.[268] First, the insiders

---

[259] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance', 8.
[260] Williamson O, *The economic institutions of capitalism,* 1985, 52.
[261] Malin C, *Corporate governance,* 20.
[262] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance', 19.
[263] Williamson O, *The mechanisms of governance,* Oxford University Press, New York, 1996, 11.
[264] Marie-Claude B et al, *The beginning of transaction cost economics: The beginning of a new direction*, 1126.
[265] Malin C, *Corporate Governance,* 21.
[266] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 92.
[267] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 92.
[268] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 92.

are usually current and former executives of the firm and they give expertise in various areas such as finance and law on the firm itself as well as providing general strategy and direction.[269] Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision-making and problem solving. [270]Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and they provide support in their individual specialized fields. Finally, those who influence the community are the political leaders, university faculty, members of clergy, leaders of social or community organizations. [271]

3.8. Path Dependence Theory

The fourth theory under this is path dependence theory. It identifies two sources of path dependence; structure driven and rule driven.[272] It was extensively developed by Mark Roe and Lucian Bebchuk, who made the point that corporate structures depend on the structures with which the economy started.[273] In their own words, 'initial ownership structures can affect both the identity of the rules that would be efficient and the interest group politics that can determine which rules would actually be chosen.'[274] Path dependence is remarkably commonplace as it is hardly controversial to suggest that initial conditions matter, that ideologies and accidents affect the design of institution and that past decisions shape current choices. If this sounds familiar, it's because historians have been telling us the same for some time now. In-fact historians have had their go at economists saying, 'path dependent is the term economists use because they can't get themselves to say the word history.'[275]

---

[269] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 92.
[270] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 92.
[271] Abdullah H and Valentine B, 'Fundamentals and ethics theories of corporate governance', 92.
[272] Malin C, *Corporate Governace*, 21.
[273] Bebchuk L and Roe M, 'A Theory of Path Dependence' 52 *Stanford Law Review* 1, 1999.
[274] Bebchuk L and Roe M, 'A Theory of Path Dependence', 129.
[275] Mann R and Milhaupt C, 'Path Dependence and Comparative Corporate Governance', 74 *Washington University Law Review* 2, 1996, 321.

Some have concluded that path dependency makes institutions matter in only two circumstances: when they fit the dominant character and technology of industrial production in a given economy and when they act as 'guardrails', continuously channelling movements along a well-worn path.[276] Others have issued a warning, stating that uncritical application of this path dependence theory could obscure the economic constraints that influence firm monitoring and decision making in market economies worldwide.[277]

The question left is what is the promise of path dependence to corporate governance? A path dependence perspective facilitates meaningful systems analysis of competing governance by allowing us to see the choices, or the lack thereof, that shape the development of institutions.[278] The lens of path dependence enables us to liberate corporate governance theories from their focus on static equilibrium responses to specific governance problems.[279]

The fifth and penultimate theory falling under this discussion is institutional theory. Institutional theory looks at the institutional environment, its influence on societal beliefs and practices which impact on various 'actors' within society.[280] Because of its insights into the nature of authority and control structures, the institutional theory is uniquely positioned to provide important contributions to scholarship on corporate governance.

The sixth and final theory being discussed is network governance. It has been argued that companies should have a structure of network governance and those in support of this argument suggest increasing board level information processing and decision making capabilities by including multiple boards for different stakeholders to create a division of power and labour which would support superior risk management.[281] Furthermore an ecological form of network governance could reduce the size, scope, cost and

---

[276] Mann R and Milhaupt C, 'Path Dependence and Comparative Corporate Governance', 322.
[277] Mann R and Milhaupt C, 'Path Dependence and Comparative Corporate Governance', 322.
[278] Mann R and Milhaupt C, 'Path Dependence and Comparative Corporate Governance', 323.
[279] Mann R and Milhaupt C, 'Path Dependence and Comparative Corporate Governance', 324.
[280] Malin C, *Corporate Governance*, 21.
[281] Malin C, *Corporate Governance*, 21.

intrusiveness of government and their regulators while improving economic efficiency, resiliency and enriching democracy with widespread citizen stakeholder engagement.[282]

3.9. Conclusion

This chapter sets out to discuss the various theories underlying the development of corporate governance and the areas it encompasses. The findings show that the development of corporate governance has been affected by theories from a number of disciplines, including finance, economics, accounting and law. The main theory was also seen to be agency theory, although stakeholder theory is coming into play because it takes into account a wider group of constituents rather than focusing just on shareholders. The critiques and justification for each theory was also taken into account.

In conclusion, it is fair to say that corporate governance is still seeking its theoretical foundations and as yet does not have a single widely accepted theoretical base that adequately reflects its reality.

[282] Malin C, *Corporate Governance*, 21

CHAPTER FOUR

Corporate Governance Regulation Systems

4.1. Introduction

The first chapter of this study established that the main issue with the guidelines for corporate governance are premised on a 'comply or explain' approach. This threshold as highlighted in the paper is unable to hold directors and internal auditors accountable before the consequences of bad governance crystalize. This study hopes to come up with possible solutions by suggesting preventive legal measures that will engender good corporate governance in institutions.

The study is focused on corporate governance in the banking sector and the second chapter highlighted the corporate governance regime in the sector with emphasis on its failures. The chapter also looked at the historical perspective of corporate governance in Kenya and its adoption in the banking sector.

The failure of corporate governance in the banking sector was illustrated by the collapse of Chase Bank, Imperial Bank and the Bank of Dubai. It was clear that the failure of the three banks was on account of poor corporate governance practices. Chapter two brought to the fore the shortcomings of the 'comply and explain' rule in ensuring most banking institutions adhere to rules of good governance. The overarching research question that the study seeks to answer is whether corporate governance is failing within the banking sector in Kenya primarily due to lack of sufficient preventive legal measures.

In an attempt to get a solution, this chapter will undertake a comparative study of corporate governance in the USA, the UK and in Kenya. In so doing, we will delve into possible approaches such as the half mandatory half explanatory found in the USA under the Sarbanes-Oxley Act as a possible intervention to the lack of preventive legal measures. The comparative study will inquire into the practicality of any proposed approach from an implementation perspective.

The rationalisation for using the US and the UK for this comparative study is that they represent two of the most advanced countries in terms of corporate governance.[283] Further, the US patterned its system after the UK, so this provides an appropriate comparison for Kenya, which also copied a lot from its former colonial master.

Scholars of corporate governance globally appear to be in agreement that there are two basic corporate governance systems viz. the Anglo-American Shareholder system and the Continental European/Japanese Stakeholder system.[284] The two models are used in contrast to explain differences in finance, ownership, labour relations, the role of the market as well as to explore the possibilities of convergence or continued divergence in corporate governance practices.[285]

The three jurisdictions this section wishes to compare and contrast all fall within the Anglo-American shareholder system. Scholars have shown more interest in the differences between the basic models; the Anglo-American shareholder system and the Continental European/Japanese Stakeholder system. Not much attention has been paid to the differences within the Anglo-American shareholder system present in Kenya, USA and the UK. Although there are significant similarities, there exist salient differences that call for discussion. There is a lot that can be learnt from our British and American counterparts on how to ensure compliance with good corporate governance.

4.2. Application of the Agency Theory

As discussed previously and in detail in the third chapter, the main features in the Anglo-American shareholder system (and that are present in Kenya, USA and the UK) can be linked to the agency theory. The agency theory is considered to have had the most

---

[283] Mintz S, 'A Comparison Of Corporate Governance Systems In The US, UK And Germany'3(4) *Corporate Ownership and Control*, 2006, 25.

[284] Aguilera R, Williams C and Conley J and Rupp D, 'Corporate Governance and Social Responsibility: a comparative analysis of the UK and the US', 3rd International Corporate Governance Conference, 4 July 2005 at the Centre of Corporate Governance Research, Birmingham Business School, 147.

[285] Aguilera R *et al,* Corporate Governance and Social Responsibility: a comparative analysis of the UK and the US', 147.

influence in the development of corporate governance as well as providing the theoretical framework.[286]

The study will compare the corporate governance systems in Kenya, USA and the UK from an Agency Theory perspective. The objective is to identify the differences and similarities within their corporate governance systems. In this regard, there will be two main points of comparison. The first is ownership, which will consider the main shareholders in each country and how that influences corporate governance. The second is control, which will consider how the law in each country understands directorship.

4.3. Corporate Governance Regulation in the US

4.3.1. Ownership

Review of scholarship in the area of corporate governance reveals that most corporate governance systems can be categorised into two: a dispersed ownership system and a concentrated ownership system. A dispersed ownership system is characterised by strong securities, rigorous disclosure systems, high share turnover and high market transparency in which the market for corporate constitutes the ultimate disciplinary mechanism while a concentrated ownership system is characterised by controlling block holders, weaker security markets, high private benefits of control and lower disclosure and market transparency but with a possibly substitutionary role played by large banks and non-controlling block holders.[287]

In the USA the ownership system is the dispersed ownership system.[288] It is widely accepted that this system is susceptible to gatekeeper failure as illustrated by the wave of financial irregularity in the USA culminating in the Sarbanes - Oxley Act. However, it should be noted that while gatekeeper failure is present in both ownership systems, in dispersed ownership systems the villains are managers and the victims are shareholders.[289]

---

[286] Malin C, *Corporate Governance,* Oxford University Press, 5 ed, Oxford, 2016, 16.

[287] Coffee J, 'A Theory of Corporate Scandals: Why the USA and Europe Differ' 21 *Oxford Review of Economic Policy* 2, 2005, 200.

[288] Coffee J, 'A Theory of Corporate Scandals: Why the USA and Europe Differ', 207.

[289] Coffee J, 'A Theory of Corporate Scandals: Why the USA and Europe Differ', 207.

Before proceeding it is crucial for the study to address what a gatekeeper is and what constitutes gatekeeper failure. The phrase "corporate gatekeeper" typically refers to external agents—auditors, analysts, credit rating agencies, and the like. Coffee lays out three criteria that define a gatekeeper as an independent professional who: (1) acts as reputational intermediary between the corporation and investors, (2) is positioned to prevent wrongdoing, and (3) is susceptible to significant reputational capital to depreciation or depletion if he or she were found to have condoned wrongdoing.[290] When they are unable to protect dispersed investors in the ownership system in USA, UK and Kenya (the dispersed ownership system) we can reasonably term it gatekeeper failure.

Moving on, we proceed to look at the different forms of ownership in the USA, UK and Kenya. These are: Executive ownership, board ownership, employee ownership (non-executive), block holders, agent owners and private equity. These can be grouped into inside ownership; executives, board and employees and outside ownership; block holders, agent and private equity.

Inside ownership is meant to cure a fundamental problem of agency relationships. A little background is needed here. For Eisenhardt, agency theory is concerned with resolving two problems that can occur in agency relationships; 1) conflicting desires between the principal and the agent and 2) the difficulty and the high costs involved when the principal tries to verify what the agent is doing.[291]

Eisenhardt is not alone in identifying the problems with the agency relationship discussed in agency theory. Indeed, we can confidently say that potential problems with agency theory are quite well documented. As early as the 18th Century, Smith pointed out that the directors of corporations being managers of other people's money rather than their own, cannot be expected to watch over it with the same anxious vigilance as if it were their own.[292]

---

[290] Coffee J, *Gatekeepers: The Professions and Corporate Governance,* Oxford University Press, 2006.
[291] Eisenhardt K, 'Agency Theory: An assessment and Review', 58.
[292] Malin C, *Corporate Governance,* 19.

This problem can be expressed as self-interest or opportunism on the part of the agent.[293] In agency theory the shareholder expects the agent to act and make decisions in the best interests of the shareholder. However this many not always be the case and there are a number of dimensions to this; the agent may not act in the interest of the principal at all, he may act just partially in the interest of the principal, information asymmetry where the agent has access to more information and thus putting the principal at a disadvantage.[294] The position that agents will always act in their self-interest is one put forward by those who, using the economic model of rationality, assume that rational individuals are self-interested and act only from egoistic or altruistic motives.[295]

These are the problems inside ownership seeks to resolve. The managerial mischief that is likely to occur when interests of firm's owners and managers diverge. It has been suggested that the firms can solve this problem by aligning agent and owner interests either through agent's equity ownership or structure of their compensation.[296]

Incentive alignment of this kind includes two related elements. The first being financial alignment, whereby an agent's economic rewards are in line with those of owners through ownership.[297] This is what this subsection looks at, inside ownership. The second element of incentive alignment is alignment of preferences and actions, whereby the agent's preferences become more aligned with those of owners, and the agent's choice of actions, though still motivated by self-interest, is more consistent with owner interests.[298] Having looked at the benefits of inside ownership, it is apt to take a closer look at the forms of inside ownership in the UK, USA and Kenya. It should be noted that these forms of ownership are present across all three and are discussed simultaneously.

---

[293] Malin C, *Corporate Governance,* 17.

[294] Malin C, *Corporate Governance,* 17.

[295] Heath J, 'The Uses and Abuses of Agency theory' 19 *Business Ethics Quarterly* 4, 2009, 503

[296] Nyberg A and Fulmer I, 'Agency Theory Revisited: CEO Return and Shareholder Interest Alignment' 53 *Academy of Management Journal* 5, 2010, 1029.

[297] Nyberg A and Fulmer I, 'Agency Theory Revisited: CEO Return and Shareholder Interest Alignment', 1029.

[298] Nyberg A and Fulmer I, 'Agency Theory Revisited: CEO Return and Shareholder Interest Alignment', 1029

The first is executive ownership. Executive ownership is simply executives (managers) own equity with the appeal being that as executives have greater ownership stake, they are more likely to employ firm resources towards long-term profitability and less likely to shirk from executing their fiscal and strategic responsibilities.[299] At the same time, however, other scholars note the potential pernicious effects of managerial ownership. High levels of ownership, for example, may provide executives with increased power, which can cause them to become entrenched within the firm.[300] Once entrenched, managers may consume more perquisites and/or reduce the firm's risk profile to protect their own interests.

Empirical research has been consistent with these contrasting perspectives on the effects of managerial ownership. Results of various studies have brought mixed results. Some studies reveal that executive ownership leads to greater risk taking whereas others report the opposite, less risk taking.[301] With respect to goal alignment, results have been similar. Some studies have sought to establish a link between managerial ownership and goal alignment, but other research has found that managerial ownership may as often lead to goal misalignment with respect to such issues as backdating of stock options, earnings manipulation, and dividend policies.[302]

Board ownership is the second type of inside ownership and is quite similar to executive ownership. They are both meant to achieve goal alignment. The difference is that board ownership refers to independent directors that sit on the board. However, there hasn't been research on these outside directors holding equity as from an agency theory perspective, they should represent the interests of shareholders.[303]

The third type of inside ownership is non-executive employees owning at least some stock in the firm. Thousands of firms are structured this way in the UK and the USA not only

---

[299] Connelly B, Hoskisson R, Tihanyi L, Certo T, 'Ownership as a Form of Corporate Governance' 47 *Journal of Management Studies* 8, 2010, 1564.
[300] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1564.
[301] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1564.
[302] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1565.
[303] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1565.

to achieve goal alignment but also to create a socio-psychological bond that affects job attitudes positively.[304] This socio-psychological bond is linked to effectiveness, satisfaction and job performance.[305]

Outside ownership is seen by some as complimentary to the alignment approach seen in inside ownership, since it may motivate shareholders to monitor the activities of managers closely.[306] It is also known as the control approach. Before proceeding it is important to note that much of the literature on individual ownership is focused on inside owners such as executives. Individual owners are often ignored or lumped together with institutional investors when discussing outside ownership. It should be noted as well that the forms of outside ownership discussed here are found across the board in USA, the UK and Kenya.

The first type of outside ownership has to do with block holders. These are investors with more than a 5% equity stake in a firm.[307] In essence, block holders are large shareholders. They have a huge role to play in corporate governance because their sizeable stakes give them the most incentive to bear the cost of monitoring managers.[308] Block holders can be private individuals, family members, institutional investors such as firms and corporations or state ownership. Block holders are mainly motivated by two factors; concentrated control and private benefit. Concentrated control arises from the superior monitoring that block holders can perform via concentrated decision rights while private benefits are those that accrue through their ability to use their power over management.

Individual block holders tend to be inside block holders and are therefore part of inside ownership. Institutional block holders, on the other hand are firmly part of outside ownership and examples of such institutions include banks, insurance firms and pension funds. Some scholars conjecture that institutional investors gravitation towards companies that have better governance structures is likely to be stronger than that of individual

---

[304] Connelly B *et al,* 'Ownership as a Form of Corporate Governance', 1565.
[305] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' ,1565.
[306] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1566.
[307] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1564.
[308] Edmans A, 'Blockholders and Corporate Governance' National Bureau of Economic Research, NBER working paper series Number 19573, 2013, 2.

investors.[309] This is based on institutional investors having strong fiduciary responsibilities since most of them are banks, insurance companies and pension funds as well as the tendency of institutional investors having more incentive to monitor managers more actively due to the large stake they hold. Further, institutional investors know that they need to do more monitoring and tend to prefer firms which have better disclosure rankings and in turn better governance structures to reduce monitoring costs.

State ownership in the USA is not very popular and this has been attributed to its status as a developed country and its libertarian mindset. This is because state ownership tends to be higher in emerging economies and those with poorer protection of property rights. However, this is not to say that there is no state ownership in developed countries such as the USA, state ownership occurs in this country where it steps in as a result of market failures.

State ownership in the USA takes the form of subtle around investors that are broadly categorized as sovereign wealth funds (SWFs); these are investment vehicles owned and managed by a national government. [310] SWF's have invested large sums of capital into firms in the USA and the UK and this has led to concern over their transparency and their potential for preferring political interests and gains over economic and strategic gains.[311] However most of the evidence for such claims appear to be anecdotal as there isn't too much academic research into it.

The final type of outside ownership present in the USA is agent ownership. Agent owners are a set of outside owners that invest in the firm as representatives of an underlying fractionated ownership.[312] This creates a dual agency relationship wherein shareholders serve as principals, discharging duties with regard to managerial agents, and also as agents

[309] Chung K, 'Corporate Governance and Institutional Ownership' 46 *Journal of Financial and Qualitative Analysis* 1, 2009, 6.
[310] Connelly B *et al,* 'Ownership as a Form of Corporate Governance' 1564.
[311] Connelly B *et al,* 'Ownership as a Form of Corporate Governance', 1564.
[312] Connelly B *et al,* 'Ownership as a Form of Corporate Governance', 1564.

who are themselves charged with the duty of investing towards particular objectives of ultimate shareholders in a particular fund.

There are multiple grounds to make one believe that agent owners are able to overcome obstacles to firm governance encountered by other shareholders. Agent owners represent fractionated clients who sign over their voting rights, centralizing bargaining power in a single entity and avoiding campaign costs.[313] Owing to a changing regulatory environment witnessed in UK and USA in their favour, agent owners can sometimes combine their bargaining strength.[314] With their large holdings, these owners have the incentive and resources to monitor firm actions.

Institutional ownership is the most popular in the USA. A study of the top 1000 corporations reveals they have institutional ownership of up to 73%.[315] 96% of US firms have at least one block holder and as discussed earlier block holders tend to be institutions.[316] In the analysis of corporate governance in the USA, any meaningful discussion ought to begin with the fact that between 60% and 70% of the shares of medium and large public corporations are held by institutional investors, and that even in the largest corporations, a significant percentage of the shares are held by a handful of investors. Two factors seem to have driven the trends over time: regulation; and market forces. The extraordinary growth of institutional investors in the US is as a result of two key factors: regulation and market forces.[317] An example of such regulation is the enactment of the Employee Retirement Income Security Act of 1974 (ERISA) a federal law that sets minimum standards for most voluntarily established retirement and health plans in private industry to provide protection for individuals in these plans.

This eventually pushed corporations to shift to "defined contribution" plans in which the employer and employee each contribute to a tax-advantaged retirement account (almost

---

[313] Connelly B *et al,* 'Ownership as a Form of Corporate Governance', 1564.

[314] Connelly B *et al,* 'Ownership as a Form of Corporate Governance', 1564.

[315] Rock E, 'Institutional Investors in Corporate Governance' *Faculty Scholarship University of Pennsylvania,* paper 1458, 5.

[316] Edmans A, 'Blockholders and Corporate Governance', 2.

[317] Rock E, 'Institutional Investors in Corporate Governance',5.

invariably managed by a mutual fund) to support the employee after retirement. From an employer's perspective, the great virtue of a "defined contribution" plan is that it is fully funded from the beginning and all investment risk falls on the employee. Thus, began the growth of institutional investors in the US.

4.3.2. Control in the US

The US follows the Anglo- American model that is based on a single tiered (one-tiered) Board of Directors, which is primarily comprised of non-executive directors who have been elected by shareholders. Some single tiered boards have both executive and non-executive directors, while others may have the CEO serving as the Chairman of the Board, creating CEO/Chair duality, and then utilizing separate functional committees, for example, audit, nomination and compensation committees. [318]

One should not gloss over the importance of the board of directors in corporate governance given the multiplicity of agency control mechanisms available to it and in operation.[319] The Board of Directors which has the power to hire, fire, and compensate senior managers teams serves to resolve conflicts of interest among decision maker residual risk bearers. This economizes the transaction (agency) costs associated with the separation (specialization) of ownership and control and the survival of the open corporation as an organizational form. Thus, it is not surprising to find that state corporation laws, in the US, require that the affairs of business corporations be managed under the guidance of a board of directors.[320]

Initially in the US, there was a *laissez-faire* attitude towards board of directors as the law was silent on board composition, size, structure, director compensation, ratio of insiders to outsiders, organisational affiliations of outsiders and even matters as salient as independence of directors both individually and as a group.[321] Inevitably these led to

---

[318] Rock E, 'Institutional Investors in Corporate Governance',5.

[319] Baysinger B and Butler H, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' 1 *Journal of Law, Economics, & Organization* 1, 1985, 105.

[320] Baysinger B and Butler H, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition', 105.

[321] Baysinger B and Butler H, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in

shareholder abuses as selection of directors was left virtually at the discretion of the very parties whose behaviour the board was supposed to monitor.

Following the financial failures of Enron and other major corporations in the early 2000's, there was an increased interest in corporate governance and questions were raised as to the adequacy of the regulations in force which scrutiny gave impetus for the passage of the Sarbanes-Oxley Act in 2002 which was an addition to the Securities Acts of 1933 and 1934 and legislated specific revisions to the framework for corporate governance in the United States.[322]

The Sarbanes-Oxley Act addressed many of the problems resulting from an unregulated board of directors by requiring that a majority of the directors on the board be independent, requiring independent director approval of director nominations and executive officer compensation, expanded the scope of audit committee authority and tightened the qualification requirements for audit committee members.[323]

4.4. Corporate Governance Regulation in the UK

Since the forms of ownership are similar to the US, we shall proceed to look at the pattern of share ownership. This pattern of share ownership in the UK reveals that institutional investors own nearly forty percent of UK equity while individual investors account for only ten percent of UK equity.[324] Overseas shareholders (who are predominantly institutional shareholders as well) own the rest. From this we can see institutional shareholders have become quite powerful in the UK and this has led to an expectation that they play an active role in the companies in which they invest. Led by Paul Myners, the Myners Review in 2001 was a wide-ranging report covering fund management, trustees, life insurance which revealed that despite their power and influence, institutional investors seemed reluctant to intervene or even take action in underperforming companies.[325]

Board Composition', 102.

[322] Meier H and Meier N, 'Corporate Governance: An Examination of U.S and European Models' 9 *Corporate Board: Role, Duties & Composition* 2, 2013, 7.

[323] Meier H and Meier N, 'Corporate Governance: An Examination of U.S and European Models', 7.

[324] Mallin C, *Handbook on International Corporate Governance: Country Analyses,* Edward Elgar Publishing Limited, 2011, 10.

[325] Mallin C, *Handbook on International Corporate Governance: Country Analyses,* 10.

In response to the findings of the Myners Review of 2001, the Institutional Shareholders Committee issued a statement on the responsibilities of institutional shareholders. In the statement they listed some of the things they felt were in the realm of responsibility of institutional shareholders such as monitoring performance and intervening when necessary. [326] Overall, the statement aimed at enhancing how effectively institutional shareholders discharge their responsibilities in relation to the companies in which they invest.[327] To their credit, the Institutional Shareholders Committee released a statement every two years from 2002 culminating in the Code on Responsibilities of Institutional Investors of 2009.[328]

In terms of control, the UK also follows the Anglo-American model that is based on a single tiered board of directors. The structure and composition of the board of directors is based on the Combined Code on Corporate Governance. This code establishes good governance practices relating to the role and the composition of the board. However, the UK operates in a 'comply or explain' system, which allows companies to adopt a different approach most suited to them.[329] The companies are only required to explain the reasons for non-compliance to their shareholders who then must decide if the approach chosen is acceptable. This 'comply or explain' approach enables judgments about many issues, including the independence of non-executive directors, on a case-by-case basis. This system exemplifies the importance of the relationship between the company and its shareholders and not between the company and the regulators which in turn, has gained strong support from companies, investors and regulators in the UK with some even claiming that 'UK was ranked as the leading country in terms of corporate governance" and these more favorable requirements were a major reason why some companies chose to list their securities in the UK rather than in the U.S.[330]

---

[326] Mallin C, *Handbook on International Corporate Governance: Country Analyses,*10.
[327] Mallin C, *Handbook on International Corporate Governance: Country Analyses*, 10.
[328] Mallin C, *Handbook on International Corporate Governance: Country Analyses,* 10.
[329] Meier H and Meier N, 'Corporate Governance: An Examination of U.S and European Models'7.
[330] Meier H and Meier N, 'Corporate Governance: An Examination of U.S and European Models', 7.

4.5. Corporate Governance Regulation in Kenya

As the forms of ownership are essentially the same, we proceed directly to the pattern of share ownership. First is state ownership, which is more common in Kenya than in the UK and the USA. In a study of ownership and corporate governance and its effects on banks the researchers asked respondents to indicate the percentage of shares owned by the state for the banks surveyed. The findings show that in the banks surveyed, though the state still had majority shares of over 70% it was evident that the state was gradually withdrawing from active participation in some banks by periodically offloading shares as some respondents noted.

As this study focuses on corporate governance in banks, it is apt to utilize a study conducted on types of ownership in Kenyan banks. 40% of the banks that participated in the study were foreign owned, 32.5% had substantive government participation while 27.5% were locally owned. Of these banks, 80% of them were listed as firms in the Nairobi Securities Exchange. At least managers and workers held between 0 -5 percent of the shares in local banks as 20% of respondents in the study noted while in foreign-owned banks employees owned up to 20% of the shares. Domestic individual investors, domestic institutional investors and foreign investors each owned up to 25% of shares.[331]

In terms of control, Kenya still utilizes the Anglo-American model of a single tiered board of directors. For banks, there a number of stipulations for the board of directors that are set out by the Central Bank of Kenya. Firstly, the board must have a non-executive director who is not involved in the day to day running as well as not being a full-time salaried employee of the banking institution or its subsidiaries and secondly the board must have an independent non-executive director who has not been employed by the institution in any executive capacity within the last five years and does not have any conflicting interests within the institution.[332] Additionally, no shareholder with more than five percent in a banking institution is allowed to be an executive director or form part of the management of the institution. The CBK has more guidelines on the board of directors

[331] Mang'unyi E, 'Ownership Structure and Corporate Governance and Its Effects on Performance: A Case of Selected Banks in Kenya', 8.

[332] Mang'unyi E, 'Ownership Structure and Corporate Governance and Its Effects on Performance: A Case of Selected Banks in Kenya', 8.

such as; all institutions' board to have at least five directors, three-fifths of whom should be non-executive Directors. For foreign banks, a local committee is a mandatory requirement.[333]

4.6. Compliance Issues

Kenya leans heavily towards the comply-or-explain framework which yields very little compliance as evinced by the failures of the banks. The 'comply or explain' framework falls short of its mandate because it does not give sufficient impetus for companies or institutions to comply. Other than the mandatory laws that are given force through statute, the other rules serve at best as pointed suggestions giving leeway for companies to decide whether or not to be bound.

The result of non-compliance has led to Kenya witnessing the collapse of at least three mid-tier banks: Dubai,[334] Imperial[335] and Chase.[336] These failures can largely be attributed to lapses in the corporate governance framework. The failure of Chase bank can be narrowed down to irregular insider lending at the behest of the directors whereas at Imperial Bank it was a conspiracy between senior bank officials to defraud depositors.[337] The failure of these banks has not only impacted depositors negatively but has affected the banking sector in its entirety.

4.7. Limits of the Law

The law on corporate governance in Kenya has clearly had its limits as demonstrated by the failures of banks. The main laws that would come into play in remedying ills of corporate governance would be The Companies Act, The Capital Markets Act and Nairobi Securities Exchange (NSE) Rules and the Penal Code. Although, the extent to which the law can promote good governance is limited, our laws are not doing enough at present.

---

[333] Mang'unyi E, 'Ownership Structure and Corporate Governance and Its Effects on Performance: A Case of Selected Banks in Kenya', 8.

[334] Joshua Masinde, 'CBK orders closure of Dubai Bank,' Daily Nation, 24 August 2015.

[335] Quartz Africa, Exotic holidays, gifts and the 380 million dollar fraud that brought down a Kenyan bank: https://qz.com/864182/exotic-holidays-gifts-and-the-380-million-fraud-that-brought-down-a-kenyan-bank/ on 13 June 2018.

[336] Mutuma Mathiu, 'Gloom for depositors as Chase Bank collapses,' Daily Nation, 7 April 2016.

[337] Daily Nation, 'How whistleblower's secret note to investors brought Chase Bank to its knees' April 10 2016.

Earlier discussions revealed how the law may have inadvertently left room for directors to exploit shareholders' interests by allowing the authorisation by co-directors of a director who may be conflicted to act regardless of the conflict. Additionally, the law provides that it is not necessary for the director to declare an interest if the other directors are already aware of it. Furthermore, there is no liability that attaches to the directors if they are guilty of making untrue statements or reckless declarations.

4.8. Conclusion

This chapter set out to undertake a comparative study of corporate governance in the USA, UK and Kenya. The involved a look into the similarities and differences of Kenya's, the UK's and USA's corporate governance systems through the lens of agency theorist's ownership and control. The findings show that institutional investors dominated ownership and control (management) is done through the board of directors.

The difference in approaches between the UK, Kenya and the USA are stark when it comes to the board of directors. The UK and Kenya have a lax comply or explain system while the USA has a mandatory compliance system courtesy of the Sarbanes-Oxley system — although some term it as half mandatory and half explanatory. This will be explored further in chapter 5 as a potential panacea to the problem at hand in Kenya. Chapter 5 will also make recommendations on the same.

CHAPTER 5

Conclusion and Recommendations

5.1. Introduction

This study set out to explore the corporate governance landscape in the Kenyan banking sector. This is in the wake of multiple failures of corporate governance in the sector as evidenced by the collapse of Chase Bank, Imperial Bank and Dubai Bank. The billions of shillings lost on account of those three banks illustrate the magnitude and impact of poor corporate governance.

The fall of these three banks had a direct co-relation with poor corporate governance. The Central Bank of Kenya (CBK) when issuing a moratorium on licensing of banks in the wake of this crisis claimed the issues were "isolated and unique to the two firms" due to weak internal governance controls and not systemic to the entire industry.[338] It is clear that they recognize the failure of the banks was occasioned by the lack of good corporate governance but to term the three incidents as isolated on the part of CBK is in my view not a true representation of the facts.

In the case of Chase Bank, its collapse was attributed to directors accessing loans irregularly. An audit conducted on the bank revealed that the directors advanced themselves up to USD 80 million. In Dubai Bank, directors engaged in dubious transactions by forcing the bank to undergo a liquidity crisis while at imperial bank it was outright conspiracy to defraud the bank. The common thread here is no doubt failure of corporate governance.

This study set out to establish how best good corporate governance can be engendered in the banking sector given the limitations of the law. This chapter seeks to summarize the main findings of the study, corresponding to the objectives set out in the first chapter. It will then proceed to make specific recommendations on regulatory reform and legal reform that would avail a more robust corporate governance framework in the Kenyan

---

[338] Central Bank of Kenya, *Declaration of Moratorium on Licencing of Banks,* 17 November 2015.

banking sector. Reforms that would put in place preventive legal measures that will compel entities to embrace good governance.

5.2. Summary of Major Findings

5.2.1. Current Corporate Governance Framework in Kenya

This subsection discusses the findings of Chapter Two. Chapter Two explored the current corporate governance framework in Kenya as well as the dynamics of its application and efficiency in regulating institutions. The chapter also analysed the factors that contributed to the failure of Dubai Bank, Chase Bank and Imperial Bank.

To understand the framework of corporate governance in Kenya, it was necessary to delve into its history. A brief historical perspective of corporate governance in the UK preceded this—as Kenya borrowed heavily from it. It was interesting to note that prior to the UK putting into place a robust corporate governance regime, they had their fair share of institutional collapses on account of poor corporate governance. The period between the 1980s and 1990s witnessed the collapse of the Ferranti International PLC, Colorol Group, Pollypeck International PLC, Bank of Credit and Commerce International (BCCI) and Maxwell Communication Corporation.

The chapter then looked at the major developments that followed in the UK aimed at addressing this failure of corporate governance. The first intervention was the Cadbury Code emanating from the Cadbury Committee chaired by Sir Adrian Cadbury which attempted to set out in writing a code that was to inform the expected standards of financial reporting and auditing and eventually be reflected in a Code of Best Practice. This may be heralded as the first attempt to codify already recognised practices and render them universally applicable as well as offer added incentive for companies to adhere to them. The code was presented to companies as being voluntary but with the caveat that companies should explain in their annual reports the extent of their compliance as well as any reasons for non-compliance - the 'comply or explain' alluded to earlier.

The Greenbury Report followed the Cadbury Report and it centred around the somewhat controversial issue of remuneration of company directors. Part of the report recommended that director's remuneration should not be excessive, that there be a direct link between shareholder interests and directors' interests, share amounts to directors should not be offered at a discount among other considerations.[339] The report further suggested that there be full disclosure provided for directors' remuneration. All this information, it was recommended, should be detailed and set out in an annual report.[340] Chapter Two also detailed the findings of the Hampel Report which echoed the Greenbury and Cadbury reports before they were all combined into the 1998 combined report which fortified the 'comply or explain' approach we see today.

This background laid the basis for a study of Kenya's history of corporate governance. The findings reveal that institutional failure is not new to Kenya. Seven banks and more than ten financial institutions had already collapsed before the turn of the year 1994. Between 2000 and 2006 six more banks collapsed. Chase Bank, Imperial Bank and Dubai Bank only seem to have perpetuated the poor corporate governance practices that have plagued our banking sector. The chapter then proceeds to look at the law governing corporate governance.

The findings reveal that Kenya has a corporate governance framework in the form of the Code of Corporate Governance Practices for Issuers of Securities to the Public 2015 and a regulatory body in the Capital Markets Authority. The various laws governing corporate governance in Kenya, include the Constitution of Kenya, the Companies Act, the Capital Markets Act, the Nairobi Securities Exchange Rules, the Banking Act, Prudential Guidelines and the Penal Code.

The chapter goes on to review these laws in an attempt to figure out the cause of their ineffectiveness. The findings reveal that the law may have inadvertently left room for directors to exploit shareholder interests by allowing the authorisation by co-directors of a director who may be conflicted to act regardless of the conflict. Additionally, the law

---

[339] Report of the Committee on Corporate Governance, January 1998, para 6.5 and 6.7.
[340] Report of the Committee on Corporate Governance, January 1998, para 5.8 and 5.12.

provides that it is not necessary for the director to declare an interest if the other directors are already aware of it. Furthermore, there is no liability that attaches to the directors if they are guilty of making untrue statements or reckless declarations

The final part of the chapter goes into more detail on the banking crisis in Kenya, analysing at length the collapse of Dubai Bank, Imperial Bank and Chase Bank. Ultimately it can easily be narrowed down to poor corporate governance practises and its perhaps indicative of a system in urgent need of preventive legal measures. Probable solutions will be discussed in the recommendations.

5.2.2. Theories of Corporate Governance

This chapter was useful in elucidating on the theories on what makes an efficient corporate governance framework. An analysis of the theories on corporate governance provides a basis for understanding the issue in greater depth. Identifying the most suitable theory for corporate governance in a country such as Kenya may not be easy. Corporate governance is a global phenomenon bringing with it legal, cultural and structural differences thus some theories may be more relevant and appropriate to one country than they are to another.

The findings revealed that the theories that affect corporate governance are quite varied as would be expected given the many disciplines that have influenced its growth. Some of the theories that may be associated with corporate governance may include; Agency, transaction cost economics, stakeholder, stewardship, class hegemony, managerial hegemony, path dependence, resource dependence, institutional, political and network governance.

The findings show that the main theory behind corporate governance systems all over the world is agency theory. Agency Theory having its roots in economic theory can be defined as the relationship between the principals, such as shareholders, and agents such as the company executives and managers.[341] Its sheer simplicity in reducing the management of

[341] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance' *Middle Eastern Finance and Economics*, 2009, 89.

a corporation to just two levels (managers and shareholders) has been deemed a major factor in its prominence.[342]

The problems of Agency Theory and its resulting agency relationship are heavily linked with the problems witnessed in the collapse of our banking institutions. This is due to the conflicting desires between the principal and the agent and leads to directors acting the way they do. In fact, as early as the 18th Century, Adam Smith put it aptly by stating that the directors of corporations being managers of other people's money rather than their own, cannot be expected to watch over it with the same anxious vigilance as if it were their own.[343]

This problem can be expressed as self-interest or opportunism on the part of the agent.[344] In Agency Theory the shareholder expects the agent to act and make decisions in the best interests of the shareholder, but the exact opposite has been witnessed in the banking crises in Kenya. Agency Theory helps in understanding the situation better especially with its view of corporations being set in the context of separation of ownership and control. With investors or shareholders being the owners and directors taking control. The challenge of self-interest as discussed earlier manifests itself quite well in the discussion on separation of ownership and control. A growing tendency among corporations has been to dilute controlling blocks of shares leading to a situation that can be described as ownership without power.[345] These powerless owners have had to watch as directors overpay themselves, scandals unfold, and failures occur.

Agency Theory is particularly crucial to this study since its regarded by some as an essential tool for analysing and understanding the spate of corporate ethics scandals.[346] The findings from investigating the Agency Theory provided this study with some mechanisms of countering the conflicts of agency relationships;

---

[342] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 89.
[343] Malin C, *Corporate Governance,* 19.
[344] Malin C, *Corporate Governance,* 17.
[345] Malin C, *Corporate Governance,* 18.
[346] Heath J, 'The Uses and Abuses of Agency theory', 03.

1. No duality, that is, one person should not hold the position of CEO and Chairman of the Board to avoid managerial opportunism and agency loss;

2. Provision of financial incentives to managers: including fixing executive compensation and levels of benefits linked to shareholders' returns;

3. Introduction and inclusion of more independent directors on the board;

4. Direct intervention by shareholders and the threat of firing the underperforming managers (shareholder activism); and

5. An active market for corporate control: The threat of a hostile takeover disciplines managerial behavior and induces managers to attempt to maximize shareholder value.

Most of these can be applied to the problems we have seen in our corporate governance system and will be discussed further in the recommendations.

The chapter then discussed Stewardship Theory, which does not stress the perspective of individualism, but rather on the role of top management being stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.[347] The theory recognizes the importance of structures that are geared and built towards maximum autonomy and trust in an effort to empower the steward. It is kind of the antithesis of agency theory, for example while agency calls for protection of shareholders' interests by separation of incumbency of roles of board and chair, stewardship theory argues that shareholders' interests are maximised by shared incumbency of these roles. In other words, the stewardship model can be summarised as one where shareholders empower and trust stewards who in turn get both intrinsically and extrinsically motivated to perform in a way that protects and maximizes shareholders' wealth.

A survey of Kenyan firms listed in the Nairobi Securities Exchange between 2004 and 2007 revealed that most surveyed firms tended to favour outside directorships over inside

[347] Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance', 90.

directorships. The prevalence of outside directorships was twice as much compared to inside directorships. This tends to favour the competing Agency Theory over Stewardship Theory. Further, the study showed that firms surveyed tended towards having different persons occupying the two positions of CEO and board chairman, something that is in line with Agency Theory.[348] These results reveal that Agency Theory is dominant over Stewardship Theory or at least more prevalent in Kenya. This dominance explains why most codes of best practice so far advanced by different bodies and countries including the CMA have some kind of bias towards implementing the Agency Theory recommendations.

The chapter then proceeded to discuss the Stakeholder Theory. The Stakeholder Theory takes into account of a wider group of constituents rather than focusing on only shareholders. The findings show that Stakeholder Theory does not provide a single corporate objective but directs managers to serve many "Masters". It became clear from the findings that without the clarity of mission provided by a single valued objective function; companies embracing stakeholder theory will experience managerial confusion, conflict, inefficiency and loss of competitive advantage.

Transaction Cost Economic Theory was the last of the major theories discussed. While agency theory looks at the tendency of directors to act in their own best interests, pursuing salary and status, TCE theory considers that managers (or directors) may arrange transactions in an opportunistic way. So how then is the Transaction Cost Economics Theory relevant to corporate governance? If assets are non-specific, there is no need of having corporate governance structures. This is because there are no complex transactions to be carried out. A simple transaction such as purchasing milk has little uncertainty to it, low asset specificity and no risk, therefore it is a straight forward transaction.[349] Therefore, the Transaction Cost Economics Theory goes ahead to explain why such simple transactions are organised in a buyer-seller market and provides insight on why complex

---

[348] Aduda J, Chogii R and Magutu P, 'An Empirical Test of Competing Corporate Governance Theories on The Performance of Firms Listed at The Nairobi Securities Exchange' 9 *European Scientific Journal* 13, 2013, 133

[349] Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance', 8.

transaction require complex governance structures.[350] Governance structures can be seen as a way of internalising and making decisions that have not been thought out in the initial contract.[351] The TCE approach ensures that governance decisions are held accountable at every decision-making level to ensure maximisation of benefit and the economisation of costs.

5.2.3. A Comparative Study of Corporate Governance

A comparative study of the USA, the UK and Kenya was imperative. In undertaking the comparative analysis, the study interrogated approaches in the USA under the Sarbanes Oxley Act as a possible solution to the lack of preventive legal measures. The comparative study considered the practicality of the proposed solution by way of in-depth analysis of the legal systems of the United Kingdom and The United States of America which have received praise for fostering strong and good protection for minority shareholders resulting in a more diversified shareholder base.[352]

The findings of the comparative study illustrated the similarities between the three countries in the field of corporate governance, which makes it easier to adopt approaches from those legal systems. The first similarity from the study was the presence of a dispersed ownership system in all three countries. A dispersed ownership system is characterised by strong securities, rigorous disclosure systems, high share turnover and high market transparency. The study then looked into the different forms of ownership in the USA, UK and Kenya. These are: executive ownership, board ownership, employee ownership (non-executive), block holders, agent owners and private equity. These can be grouped into inside ownership; executives, board and employees and outside ownership; block holders, agent and private equity.

The comparative study revealed further how the US initially faced challenges due to the *laissez faire* approach towards a board of directors, but this was resolved by the Sarbanes-Oxley Act. It fixed many of the problems resulting from an unregulated board of directors

---

[350] Williamson O, *The economic institutions of capitalism,* 1985, 52.
[351] Malin C, *Corporate governance,* 20.
[352] Malin C, *Corporate Governance,* 17.

by requiring that a majority of the directors on the board be independent, requiring independent director approval of director nominations and executive officer compensation, expanded the scope of audit committee authority and tightened the qualification requirements for audit committee members. In the UK, the structure and composition of the board of directors is based on the Combined Code on Corporate Governance. This code establishes good governance practices relating to the role and the composition of the board. However, the UK operates in a 'comply or explain' system, which allows companies to adopt a different approach most suited to them.

This section deals with recommendations; suggestions and proposals that this author believes can be successfully implemented to hold directors and internal auditors accountable before the consequences of bad governance crystallize. The recommendations are informed by the need to have preventive legal measures that behooves corporate entities to good governance.

5.3. Recommendations for Corporate Governance in Kenya

5.3.1. Mandatory Governance Legislation

From the preceding discussion in this study on corporate governance it becomes clear that the main issue with the corporate governance system in Kenya is that it works on the premise of 'comply or explain'. This threshold as highlighted in the study is unable to hold directors and internal auditors to account before the consequences of bad governance materialize.

The first recommendation of this study is that the 'comply or explain' governance system be replaced by mandatory governance rules. The Sarbanes Oxley Act introduced mandatory rules and as evidenced by the comparative study; it greatly improved their corporate governance regime. While there are many incentives for corporations to adopt corporate governance principles voluntarily, Kenyan banking institutions have not shown a propensity to do so.

The comply-or-explain regime is insufficient, since there is no guarantee that all firms will implement the reforms necessary to provide investors with adequate checks on

agency problems. On this view, mandatory corporate governance is a necessary tool for the protection of investors. A mandatory governance regime will yield better compliance and will go a long way in preventing institutional failure in the banking industry. The author proposes legal consequences for failure to meet certain guidelines. For instance, if a company fails to put in place an external remuneration committee they ought to be guilty for material non-compliance.

The Central Bank of Kenya (CBK) should enforce these consequences. Section 33 of the CBK Act gives it the power to monitor any bank in Kenya. This study focuses on poor corporate governance in banking institutions and for that reason alone if for no other, the CBK is the most appropriate body as an enforcement mechanism. The use of the CBK is ideal, as it falls squarely within their mandate.

5.3.2. Partially Mandatory; Partially Voluntary Governance Regime

It is worth noting that several institutions have adopted corporate governance practices in the absence of a requirement to do so. It is for this reason that the second recommendation calls for a part mandatory part voluntary corporate governance regime. Particularly one coupled with mandatory disclosure of a firm's governance practices. There is evidence that this part mandatory part voluntary approach is likely to yield a higher level of compliance at lower costs to the issuer than a wholly mandatory regime.[353] While a wholly mandatory structure may yield slightly better compliance, its other benefits are uncertain, and its costs are likely much higher.

For this partially mandatory partially voluntary system to work there has to be significant incentives for the voluntary initiative. This is informed by the fact that institutions will always assess the costs and benefits of possible governance practices and will voluntarily adopt practices, including making disclosures that are likely to result in the highest net

[353] Anand A, 'An analysis of enabling vs. mandatory corporate governance structures post sarbanes-oxley', December 2005. < http://www.law.harvard.edu/faculty/hjackson/pdfs/Enabling%20governanc.pdf>

benefit to them. Thus, the corporate governance regime has to make it abundantly clear that voluntarily adopting practices will not be to the detriment of the institution.

5.4. Conclusion

This chapter has made a summary of the findings of the study in accordance with the objectives set out in Chapter One. It has also made recommendations towards remedying the problems identified in Chapter One. In conclusion, the 'comply or explain' approach is insufficient in dealing with poor corporate governance practices and thus this study calls for either a wholly mandatory governance regime or a partially mandatory partially voluntary regime that is less costly than the wholly mandatory one but still protects investors. Additionally, it is my considered view that those at the helm of the institutions need to soul search as most of the failures are orchestrated by unethical conduct and not by the mere absence of an appropriate governance regime.

Bibliography

Books and Journal Articles

1. Abdullah H and Valentine B, 'Fundamental Ethics and Theories of Corporate Governance' *Middle Eastern Finance and Economics*, 2009, 89.
2. Abor J and Biekpe N, 'Corporate Governance and The Small and Medium Enterprise Sector: Theory and Implications. 7(2) *Corporate Governance: The International Journal of Business in Society,*2007.
3. Aduda J, Chogii R and Magutu P, 'An Empirical Test of Competing Corporate Governance Theories on The Performance of Firms Listed at The Nairobi Securities Exchange' 9 *European Scientific Journal* 13, 2013, 133
4. Aguilera R, Williams C and Conley J and Rupp D, 'Corporate Governance and Social Responsibility: a comparative analysis of the UK and the US', 3rd International Corporate Governance Conference, 4 July 2005 at the Centre of Corporate Governance Research, Birmingham Business School, 147.
5. Akwasi R, 'Corporate Governance and Financial Perfomance: Evidence from the Ghanian Banking Sector' PHD thesis, University of Bradford, 16.
6. Anand A, 'An analysis of enabling vs. mandatory corporate governance structures post sarbanes-oxley', December 2005. < http://www.law.harvard.edu/faculty/hjackson/pdfs/Enabling%20governanc.pdf>
7. Aras G and Crowther D, *A handbook of corporate governance and social responsibility*, Routledge, New York, 131-132.
8. Atieno Y, (2009). 'Corporate governance problems facing Kenyan parastatals: A case study of the sugar industry', Bucerius Law School, 2009 - http://www.gbv.de/dms/buls/631006060.pdf on 9 July 2018.
9. Bebchuk L and Roe M, 'A Theory of Path Dependence' 52 *Stanford Law Review* 1, 1999.
10. Chung K, 'Corporate Governance and Institutional Ownership' 46 *Journal of Financial and Qualitative Analysis* 1, 2009, 6.
11. *Code of Corporate Governance Practices for the Issuers of Securities to the Public 2015* (the 2015 Code).
12. Coffee J, 'A Theory of Corporate Scandals: Why the USA and Europe Differ' 21 *Oxford Review of Economic Policy* 2, 2005, 200.
13. Coffee J, *Gatekeepers: The Professions and Corporate Governance,* Oxford University Press, 2006.

14. Coglianese C, Healey T., Keating E and Michael M, 'The role of government in corporate governance,' John Fennedy School of Government, 2004.
15. Connelly B, Hoskisson R, Tihanyi L, Certo T, 'Ownership as a Form of Corporate Governance' 47 *Journal of Management Studies* 8, 2010, 1564.
16. Dignam A, 'Exporting corporate governance: UK regulatory system in a global economy', 21(3) *Comp L*, 2000, 70-72.
17. Donaldson L and Davis J, 'Stewardship Theory and Agency Theory: CEO Governance and Shareholder Returns' *Australian Journal of Management,* 1991,49.
18. Donaldson T and Preston L, 'The stakeholder theory of corporation: Concepts, evidence and implications' 20 *Academy of Management Review* 1, 1995, 70-71.
19. Edmans A, 'Blockholders and Corporate Governance' National Bureau of Economic Research, NBER working paper series Number 19573, 2013, 2.
20. Eisenhardt K, 'Agency Theory: An assessment and Review' 14 *The Academy of Management Review* 1, 1989, 59.
21. Fama E and Jensen M, 'Separation of Ownership and Control' 26(2) *The Journal of Law and Economics*, 1983, 304.
22. Freeman E, 'The politics of stakeholder theory: Some future directions' 4 *Business Ethics Quarterly* 4, 1994, 401-421.
23. Freeman E, Harrison J, Wicks A, Parmar B and Colle S, *The stakeholder theory: State of the art,* Cambridge University Press, New York, 2010, 3.
24. Gächter S, Orzen H., Renner E and Starmer C, 'Are experimental economists prone to framing effects? A natural field experiment', *Journal of Economic Behaviour & Organization*, 2009, 70.
25. Gakeri J, 'Enhancing Kenya's securities markets through corporate governance: Challenges and opportunities, 3(6) *International Journal of Humanities and Social Science*, 2013, 94-117.
26. Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 7(3) *International Journal of Management and Business Studies*, 2017, 9.
27. Harrison J, Freeman E and Abreu M, 'Stakeholder theory as an ethical approach to effective management: Applying the theory to multiple contexts' 17 *Review of business management* 55, 2015, 859.
28. Heath J, 'The Uses and Abuses of Agency theory' 19 *Business Ethics Quarterly* 4, 2009, 503
29. Heath J, 'The Uses and Abuses of Agency theory' 19 *Business Ethics Quarterly* 4, 2009, 503

30. Htay S and Salman S, 'Transaction cost theory, political theory and resource dependency theory in the light of unconventional aspect' 12 *Journal of Humanities and Social Science* 5, 2013, 90.
31. Institute of Directors in Southern Africa, *Draft code of governance principles for South Africa*, 2009.
32. Joshua Masinde, 'CBK orders closure of Dubai Bank,' Daily Nation, 24 August 2015.
33. Kahneman D and Tversky A, 'Prospect theory: An analysis of decision under risk', 47(2) *Econometrica*, 1979, 47.
34. Kenya Gazette Notice No 1420, March 4 2016.
35. Ketokivi M and Mahoney J, 'Transaction cost economics as a theory of the firm, management and governance' *Oxford Research Encyclopaedia of Business and Management,* 2017, 1.
36. Key S, ' Towards a new theory of the firm: a critique of stakeholder theory' 37(4) *Management Decision*, 1999, 317-328.
37. Malin C, *Corporate Governance,* Oxford University Press, 5 ed, Oxford, 2016, 16.
38. Mallin C, *Handbook on International Corporate Governance: Country Analyses,* Edward Elgar Publishing Limited, 2011, 10.
39. Mann R and Milhaupt C, 'Path Dependence and Comparative Corporate Governance', 74 *Washington University Law Review* 2, 1996, 321.
40. Meier H and Meier N, 'Corporate Governance: An Examination of U.S and European Models' 9 *Corporate Board: Role, Duties & Composition* 2, 2013, 7.
41. Mintz S, 'A Comparison Of Corporate Governance Systems In The US, UK And Germany'3(4) *Corporate Ownership and Control*, 2006, 25.
42. Mülbert P, 'Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms',2010, 3, ECGI Law Working Paper 130/2009, <http://ssrn.com/abstract=1448118>
43. Musikali M, 'The law affecting corporate governance in Kenya: A need for review', 19(7) *Social Science Research Network*, 2008.
44. Ndlovu M, Bhiri T, Mutambanadzo T, and Hlahla B, 'A comparative analysis of the corporate governance practices in multinational and domestic banks in Zimbabwe', 4(5) *Journal of Emerging Trends in Economics and Management Sciences*, 2013, 473-480.
45. Njuguna A, 'The evolution of corporate governance and consequent domestication in Kenya' 7(5) *International Journal of Business and Social Science*, 2016, 160.
46. Nyberg A and Fulmer I, 'Agency Theory Revisited: CEO Return and Shareholder Interest Alignment' 53 *Academy of Management Journal* 5, 2010, 1029.
47. Report of the Committee on Corporate Governance, January 1998, para 4.8 and 4.11.
48. Rindfleisch A and Heide J, 'Transaction cost analysis: Past, present and future applications' 61 *Journal of Marketing* 4, 1997,

49. Rose C, 'The Relationship Between Corporate Governance Characteristics and Credit Exposure in Banks: Implications for Financial Regulation' 43 Eurpoean Journal of Law and Economics 1, 2017, 167.
50. S Johnson and Upadhaya R, 'Transformation of Kenya's Banking Sector 2000-2012' in Heyer and M Kings, *Kenya's Financial Transformation in the 21st Century,* Financial Sector Deepening Kenya, Nairobi, 2015, 17.
51. Williamson O, 'The economics of organisation: The transaction cost approach' 87 *The American Journal of Sociology* 3, 1981, 548.
52. Williamson O, 'Transaction cost economics: The governance of contractual relations' 22 *Journal of Law and Economics* 2, 1979, 254.
53. Williamson O, *The mechanisms of governance,* Oxford University Press, New York, 1996, 11.
54. Yousuf A, 'Transaction costs: A conceptual framework' 2 *International Journal of Engineering and Management Sciences* 3, 2017, 133.
55. Wafula P. 'Inside Imperial Bank grand Heist: Where masterminds sank stolen sh38 Billion' The Standard, 26 Jan 2016, https://www.standardmedia.co.ke/article/2000189374/inside-imperial-bank-grand-heist-where-masterminds-sank-stolen-sh38-billion

Cases and Laws

1. *Companies Act* (Cap 486).
2. *Companies Act* (Cap 486).
3. *Penal Code* (Cap 63).
4. *Capital Markets Act* (Cap 485A).
5. *Case of Sutton's hospital* (1612), United Kingdom Court of Excheqeur.
6. Central Bank of Kenya, *Declaration of Moratorium on Licencing of Banks,* 17 November 2015.
7. Chapter 6, *Constitution of Kenya* (2010).

Online Sources

1. http://cadbury.cjbs.archios.info/report on 29 August 2018 on 29 August 2018.
2. http://web.msu.ac.zw/elearning/material/1455219768Summary%20of%20Codes.pdf 268, on 29 August 2018.
3. 273, on 29 August 2018.
4. https://en.oxforddictionaries.com/definition/incentive on 7 July 2018.
5. https://fs.blog/2017/11/hammurabis-code/ on 7 July 2018.
6. https://www.businessdailyafrica.com/corporate/Imperial--Dubai-Bank-collapse-cases-to-remain-in-the-headlines/539550-3504844-h7gpuc/index.html on 5 September 2018.
7. https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.
8. https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.
9. https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.
10. https://www.businessdailyafrica.com/corporate/Ousted-Chase-Bank-chairman-was-architect-of-Sh11bn-loot/539550-3191404-h8dxub/index.html on 5 September 2018.
11. https://www.businessdailyafrica.com/news/Sh131m--deals-with-Imperial-Bank/539546-4737290-x0rioa/index.html on 5 September 2018.
12. https://www.businessdailyafrica.com/news/Sh131m--deals-with-Imperial-Bank/539546-4737290-x0rioa/index.html on 5 September 2018.
13. https://www.nation.co.ke/business/CBK-seizes-Sh8bn-from-Chase-Bank-directors/996-3181514-oio54hz/index.html on 5 September 2018.
14. https://www.nation.co.ke/business/CBK-seizes-Sh8bn-from-Chase-Bank-directors/996-3181514-oio54hz/index.html on 5 September 2018.
15. https://www.nation.co.ke/business/Dubai-Bank-Receivership-Central-Bank/996-2833288-p0q0rf/index.html on 5 September 2018.
16. https://www.nation.co.ke/news/Rogue-bank-goes-down-with-Sh96b/1056-3150706-q2kfehz/index.html on 5 September 2018.
17. https://www.nation.co.ke/news/Rogue-bank-goes-down-with-Sh96b/1056-3150706-q2kfehz/index.html on 5 September 2018.