THE EFFECTS OF OWNERSHIP STRUCTURE ON BANK PROFITABILITY IN KENYA

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ABSTRACT

Recent years have seen increased research into the relationship between ownership structure and bank profitability. It has been widely accepted that organizational form influences operating behavior, as it defines the nature of residual claims and, thus, the motivations of the firm’s owners. This study sought to investigate the effects of ownership structure on bank profitability in Kenya. Primary data was obtained through a questionnaire that was structured to meet the objectives of the study. The study used annual reports that are available from their websites and in the Central bank of Kenya website. The study found that ownership concentration and state ownership had negative and significant effects on bank profitability while foreign ownership and domestic ownership had positive and significant effects on bank profitability. The study concludes that higher ownership concentration and state ownership lead to lower profitability in commercial banks while higher foreign and domestic ownership lead to higher profitability in commercial banks.

Keywords: ownership structure, bank profitability, ownership concentration, foreign, domestic, state.

INTRODUCTION

In a sense, ownership structure is a deep-seated problem for governance structure since it may make big effects on business incentives, mergers and acquisitions, competition and oversight of agency; and the concept is discussed by different views. The first view defined ownership structure as different types of equity such as A share, B share, outstanding share or allotment transfer, etc. (He, 1998, Zhou, 1999). A second view divided ownership structure according to its “ownership”, i.e. state shares, state-owned legal person shares, legal person shares, etc. This view sees ownership structure like the shareholder structure which refers to equity ratio occupied by various shareholders (Wu, 2003).

Background of the study

The governance of corporations has attracted much attention in the past decade. The term “corporate governance” derives from an analogy between the government of cities, nations or states and the governance of corporations (Becht et al. 2005). In Shleifer & Vishny’s (1997) survey on this topic, they pointed out that corporate governance relates to the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment. Ownership structure is like the hard core of corporate governance, a firm’s “owners,” is those persons who share two formal rights: the right to control the firm and the right to appropriate the firm’s profits, or residual earnings which in theory, could be separated and held by different classes of persons Hansmann (2000).

The connection between ownership structure and performance has been the subject of an important and ongoing debate in the corporate finance literature (Demsetz & Villalonga,
The concept of ownership structure can be defined along two dimensions: ownership concentration and ownership mix (Gursoy & Aydogan, 2002). The former refers to the share of the largest owner and is influenced by absolute risk and monitoring costs (Pedersen & Thomsen 1999), while the latter is related to the identity of the major shareholder.

**The banking industry in Kenya**

According to the Central Bank of Kenya, there are 43 licensed commercial banks in Kenya (see list in appendix 1). Three of the banks are public financial institutions with majority shareholding being the Government and state corporations. The rest are private financial institutions. Of the private banks, 27 are local commercial banks while 13 are foreign commercial banks (CBK, 2012).

Commercial banks in Kenya play a major role in Kenya. They contribute to economic growth of the country by making funds available for investors to borrow as well as financial deepening in the country. Commercial banks therefore have a key role in the financial sector and to the whole economy.

Bank financial performance in the recent past has significantly improved since 2000. Data from the Central Bank of Kenya shows a significant growth in the industry in all areas including financial performance (CBK, 2012). While this is the case, some banks, especially the foreign banks, have been performing better than others. The factors leading to this needs an investigation as has been the focus of many studies in other countries such as China, Nigeria, Singapore, UAE, UK, USA, among others.

The banking industry in Kenya has grown over the years since the Central Bank of Kenya put up measures to regulate the banks in order to streamline the activities and more so to prevent the collapse of the banking industry as had been before. Banks expand internationally by establishing subsidiaries and branches or taking over established foreign banks. This internationalization of banking systems has been encouraged by the liberalization of international financial markets (Muthungu, 2003).

**Statement of the Problem**

Empirical studies that discusses the role of ownership structure in corporate governance around the world include (Shleifer & Vishny, 1997; La Porta et al. 1999), with examples of those specifically examining the relationship between ownership structure and firm performance being (Bathala & Rao, 1995; Mitton, 2002; Ng, 2005; Vethanayagam et al., 2006). The effect of ownership structure and concentration on a firm’s performance is an important issue in the literature of finance theory (Zeitun & Tian, 2007). It is worth noting that most research on ownership structure and firm performance has been dominated by studies conducted in developed countries. However, there is an increasing awareness that theories originating from developed countries such as the USA and the UK may have limited applicability to emerging markets. Emerging markets have different characteristics such as different political, economic and institutional conditions, which limit the application of developed markets’ empirical models. Kenyan studies have been contradictory in theory findings on the relationship between ownership structure, and firm performance (e.g. Mbaabu, 2010; Muka, 2010; Ongore & K’obonyo, 2011 and Kihara, 2006). There is therefore a gap in literature as far as an industry-wide study on the effects of ownership structure on bank profitability in Kenya is concerned. This is the gap the present study seeks to bridge.
Research objectives

General Objectives

The main objective of this study was to determine the effects of ownership structure on bank profitability in Kenya.

Specific Objectives
1. To determine the relationship between ownership concentration and bank profitability in Kenya
2. To determine the relationship between domestic ownership and bank profitability in Kenya
3. To determine the relationship between foreign ownership and bank profitability in Kenya
4. To determine the relationship between state ownership and bank profitability in Kenya

Research questions
1. What is the relationship between ownership concentration and bank profitability in Kenya?
2. What is the relationship between domestic ownership and bank profitability in Kenya?
3. What is the relationship between foreign ownership and bank profitability in Kenya?
4. What is the relationship between state ownership and bank profitability in Kenya?

Importance of the study

Financial managers will be more sensitive to the influence that the various owners may have to the decisions they make with regard to the various corporate decisions such as dividend policy, investment policy and capital budgeting decisions of banks. Financial Managers will further identify whether minority investors have a role to play. The government through the regulators will be interested to know how the various owners may make decisions that may affect some sectors of the economy and come up with regulations. Policy makers will pursue economic reforms that will influence the corporate policies to be geared towards the welfare of the nation at large and protection against minority investors. This study will also guide policy makers in the banking sector especially the Central Bank of Kenya and the Treasury in coming up with policies which will spur growth and profitability in this sector. Scholars will have an insight of the relationship between various owners and corporate policies and profitability of banks.

THEORETICAL REVIEW

Agency theory

Agency theory suggests that the firm can be viewed as a nexus of contracts between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents. The primary agency relationships in business are those between stockholders and managers; and between debt holders and stockholders. These relationships are not necessarily harmonious; indeed, agency theory is concerned with so-called agency conflicts, or conflicts of interest between agents and principals. This has implications for, among other things, corporate governance and business ethics. When agency
occurs it also tends to give rise to agency costs, which are expenses incurred in order to sustain an effective agency relationship. Accordingly, agency theory has emerged as a dominant model in the financial economics literature, and is widely discussed in business ethics texts. Agency theory in a formal sense originated in the early 1970s, but the concepts behind it have a long and varied history (Bowie & Edward, 1992).

The principal-agent model suggests that managers are less likely to engage in strictly profit maximizing behavior in the absence of strict monitoring by shareholders (Prowse, 1992; Agrawal & Knoeber, 1996). Therefore, if owner-controlled firms are more profitable than manager controlled firms, it would seem that concentrated ownership provides better monitoring which leads to better performance.

Resource Based View

Resource Based View (RBV) holds that firms can earn sustainable super-normal returns if and only if they have superior intangible resources that are protected by some form of isolating mechanism preventing their diffusion throughout industry. According to Wernerfelt (1984) & Rumelt (1984), the fundamental principle of the RBV is that the basis for a competitive advantage of a firm lies primarily in the application of the bundle of valuable resources at the firm’s disposal. To transform a short-run competitive advantage into a sustained competitive advantage requires that these resources are heterogeneous in nature and not perfectly mobile (Barney, 1991; Peteraf, 1993).

Essentially, these valuable resources become a source of sustained competitive advantage when they are neither perfectly imitable nor substitutable without great effort (Barney, 1991). In a nutshell therefore, to achieve these sustainable above average returns, the firm’s bundle of resources must be valuable, rare, imperfectly imitable and non-substitutable (Barney, 1991). The extent to which external and internal factors affect managerial discretion will depend on, among other factors, the manager’s locus of control, perception of discretion and the amount of power that people perceive the manager to possess.

Foreign shareholders are endowed with good monitoring capabilities, but their financial focus and emphasis on liquidity results in them unwilling to commit to a long-term relationship with the firm and to engage in a process of restructuring in case of poor performance. These shareholders prefer strategies of exit rather than voice to monitor management (Aguilera &Jackson, 2003). Consequently, foreign shareholders are postulated to have a moderate impact on firm performance. Domestic shareholders possess characteristics that represent the worst of both worlds. Their financial focus leads to short-term behavior and a preference for liquid stocks while their domestic affiliation often results in a complex web of business relationship with the firm and other domestic shareholders (Claessens et al., 2000; Dharwadkar et al., 2000). Therefore, these shareholders are expected to have a negative influence on firm performance.

Institutional Theory

Institutional theory emphasizes the influence of socio-cultural norms, beliefs and values, regulatory and judicial systems on organizational structure and behavior. Institutions regulate economic activities through formal and informal rules as a basis for production, exchange and
distribution (North, 1990). In addition to these features, emerging economies are characterized by greater imperfections in the markets for capital, products and managerial talent. These lead to so-called institutional voids - a situation when specialized intermediaries who typically provide these services in developed economies are absent (Khanna & Palepu, 2000). It presents an opportunity for some firms, which have the necessary resources and capabilities to bridge these institutional voids.

Business groups are particularly well suited to provide the necessary welfare enhancing functions to plug these institutional voids because of their superior ability to raise capital, train and rotate managerial talent among group firms, and use common brand names in marketing their products. On the downside, though, some of these institutional voids and ineffective protection of minority shareholder and creditor rights lead to greater entrenchment by controlling shareholders resulting in conditions ideally suited for expropriation of disadvantaged stakeholders.

**Conceptual framework**

**Independent variables**

- Ownership Concentration
  - percentage of shares held
- Domestic Ownership
  - Individual
- Foreign Ownership
  - Individual
  - Institutional
- State Ownership
  - Majority shareholding
  - Full Ownership

**Dependent Variable**

- Bank profitability
  - ROE

**Ownership Concentration**

The effect of ownership concentration on company profitability has been studied since Berle & Means (1932). Other studies comparing profitability of manager–and owner–controlled companies, often categorized by the share of the largest owner, generally found a higher rate of return in companies with concentrated ownership (Cubbin & Leech, 1983). These studies, however, were seriously lacking a theoretical foundation. They neither used nor provided a theory of ownership structure and seemed to imply that shareholders could increase profit by rearranging their portfolios. This point was emphasized by Demsetz (1983) who argued theoretically that the ownership structure of the firm is an endogenous outcome of the competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organization of the firm.
A study conducted in Kenya by Ongore & K’Obonyo (2011) on interrelations among ownership, board and manager characteristics and firm performance in a sample of 54 firms listed at the Nairobi Stock Exchange (NSE). Using PPMC, Logistic Regression and Stepwise Regression, the paper presents evidence of significant positive relationship between foreign, insider, institutional and diverse ownership forms, and firm performance. However, the relationship between ownership concentration and government, and firm performance was significantly negative. The role of boards was found to be of very little value, mainly due to lack of adherence to board member selection criteria. The results also show significant positive relationship between managerial discretion and performance. Collectively, these results are consistent with pertinent literature with regard to the implications of government, foreign, manager (insider) and institutional ownership forms, but significantly differ concerning the effects of ownership concentration and diverse ownership on firm performance.

**Domestic Vs Foreign Ownership**

Evidence across many countries indicates that foreign banks are on average less efficient than domestic bank (Wahid & Rehman, 2009; Hasan & Hunter, 1996; Mahajan et.al, 1996; Chang et. al, 1998). A more recent cross border empirical analysis of France, Germany, Spain, the UK and the U.S. found that domestic banks have both higher cost efficiency and profit efficiency than foreign banks (Berger et.al, 2000). It is important to note however, that similar to other banking research, most of literature has focused primarily on developed countries, particularly the United States (Clarke et.al, 2003). Studies that have not used the U.S. as the host nation in the analysis, have found that foreign banks have almost the same average efficiency as domestic banks (Vander, 1996; Hasan & Lozano - Vivas, 1998). And studies that compared industrialized and developing countries have found that while foreign banks have lower interest margins, overhead expenses, and profitability than domestic banks in industrialized countries, the opposite is true in developing countries (Clarke et.al, 2003). Studies that have not used the U.S. as the host nation in the analysis, have found that foreign banks have almost the same average efficiency as domestic banks (Clarke, et al., 2001) and within the U.S. that foreign banks have been relatively less profitable because they valued growth above profitability (DeYoung & Nolle, 1996). Within developing countries, the reasoning suggested for the improved performance of foreign over domestic banks included exemption from credit allocation regulation and other restriction, market inefficiencies and outmoded banking practices that allow foreign banks better performance (Claessens, Demirgüç- Kunt, & Huizinga, 2000).

There have been different lines of reasoning put forward for the relatively lower performance of foreign banks compared with domestic in industrialized countries. These include different market, competitive and regulatory conditions between industrialized and developing countries (Claessens, et al., 2000); home field advantage of domestic banks (Clarke, et al., 2001) and within the U.S. that foreign banks have been relatively less profitable because they valued growth above profitability (DeYoung & Nolle, 1996). Within developing countries, the reasoning suggested for the improved performance of foreign over domestic banks included exemption from credit allocation regulation and other restriction, market inefficiencies and outmoded banking practices that allow foreign banks better performance (Claessens, Demirgüç- Kunt, & Huizinga, 2000).

**State Ownership**

Following the 2002 World Development Report, Boubakri et.al (2002) suggested 3 arguments justifying state over private ownership of bank namely that private banks are more prone to crisis; that excessive private ownership may limit access to credit to many parts of society; and finally that the government is more fitted to allocate capital to certain investment
Two additional theories have also been advanced for government participation in the financial market, namely, the development view and the political view. The development view suggests that in some countries where the economic institutions are not well developed, government ownership of strategic economic sectors such as banks is needed to jumpstart both financial and economic development and foster growth. The political view suggests that governments acquire control of enterprises and banks in order to provide employment and benefit to supporters in return for votes, contributions and bribes. Such approach is greater in countries with underdeveloped financial system and poorly developed property rights. Under the development view governments finance projects that are socially desirable. In both views, the government finances projects that would not get privately financed (La Porta, et.al, 2002).

While such arguments have some validity, recent evidence however point to the costs of government ownership of banks, suggesting that state ownership have a depressing impact on overall growth (La Porta, et.al, 2002). There is a strong negative correlation between the share of sector assets in state banks and a country’s per capita income level. Greater state ownership of banks tends to be associated with lower bank efficiency, less saving and borrowing, lower productivity, and slower growth (Barth et.al, 2000). Even government residual ownership is likely to have an effect on performance (Boubakri, et al, 2002). Majority of research indicate that private ownership of banks is associated with superior economic performance (Lang & So, 2002; Cornett et.al. 2000).

Theoretically this is consistent with the agency relationship hypothesized by Jensen & Meckling (1976). State ownership would be deemed inefficient due to the lack of capital market monitoring which according to the Agency theory would tempt manager to pursue their own interest at the expense of the enterprise. Managers of private banks will have greater intensity of environmental pressure and capital market monitoring which punishes inefficiencies and makes private owned firms economically more efficient (Lang & So, 2002).

**RESEARCH METHODOLOGY**

The study used a descriptive study design. Data was drawn from all the registered banks by the Central Bank of Kenya. According to the central bank of Kenya, there were 43 licensed commercial banks in Kenya. The study also used annual reports that are available from their websites and in the Central bank of Kenya website. Data was obtained for a five year period from 2007 to 2011. Data was collected through the use of questionnaires. The findings of the pilot study illustrates that all the instruments were reliable (CVI = 0.70)

The study used a form of the following simple linear regression equation

\[ Y = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + \epsilon \]

Where:-

- \( Y \) – is the return on equity (ROE)
- \( X_1 \) – Ownership Concentration which is the sum of the holdings of the largest five block holder shareholders.
- \( X_2 \) – Foreign Ownership which is the total value of the shares held by foreign owners
- \( X_3 \) – Domestic Ownership which is the total value of the shares held by the citizens of the country
- \( X_4 \) – State ownership which is the total value of the shares held by the Government
- \( a \) – is the constant
- \( \epsilon \) - Error term
The data collected was analyzed using regression and correlation analysis. Data was analyzed to establish whether or not a relationship exists between the ownership structures of commercial banks and their performance.

RESULTS AND DISCUSSION

Descriptive Analysis Results

The study found that Return on Equity ranged from 25% to 83% with a mean of 62% and a standard deviation of 11%. Performance of banks as measured by ROE was therefore high as they made an average of 62% return on their equity. Ownership concentration ranged from a low of 43% to a high of 75% with a mean of 52% and a standard deviation of 12%. Thus, on average banks had ownership concentration of 52% meaning that half of the shares were owned by blockholders in most of the banks. The study found that the number of shares owned by foreigners ranged from a low of 2,450,356 to a high of 27,125,450 with a mean of 15,475,025 and a standard deviation of 5,452,654. The study also found that the shares owned by domestic investors ranged from a low of 13,452,147 to a high of 75,450,689 with a mean of 48,632,450 and a standard deviation of 14,452,457. The study further found that state ownership ranged from a low of 2,540,478 shares to a high of 85,456,812 shares with a mean of 64,321,461 shares and a standard deviation of 10,458,610 shares.

Correlation and Regression Results

The results show that there were low correlation between the independent variables and therefore no serial correlations between the variables. None of the correlations between the independent variables was significant. On the other hand, the independent variables all had significant effects on performance as measured by ROE. Ownership concentration and state ownership had negative correlations with performance while foreign and domestic ownership had positive correlations with performance.

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<thead>
<tr>
<th>Table 4.1</th>
<th>Effects of ownership structure on bank profitability</th>
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<tr>
<td></td>
<td>Return on Equity</td>
</tr>
<tr>
<td>Constant</td>
<td>1.192</td>
</tr>
<tr>
<td>Ownership Concentration</td>
<td>-1.727 (.002)</td>
</tr>
<tr>
<td>Foreign ownership</td>
<td>1.947 (.001)</td>
</tr>
<tr>
<td>Domestic Ownership</td>
<td>1.175 (.021)</td>
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<tr>
<td>State Ownership</td>
<td>-0.048 (.016)</td>
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<tr>
<td>R</td>
<td>.976</td>
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<tr>
<td>R²</td>
<td>.953</td>
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<td>F</td>
<td>2.536 (.002)</td>
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</table>

The study sought to determine the relationship between ownership concentration and bank profitability in Kenya. Ownership concentration ranged from a low of 43% to a high of 75% with a mean of 52% and a standard deviation of 12%. The results show that ownership concentration had a negative and significant effect on bank profitability ($\beta = -1.727$). This effect was significant at 5% level of confidence. What this means is that higher levels of ownership concentration lead to lower profitability in commercial banks.

The study sought to determine the relationship between foreign ownership and bank profitability in Kenya. The study found that the number of shares owned by foreigners ranged from a low of 2,450,356 to a high of 27,125,450 with a mean of 15,475,025 and a standard
deviation of 5,452,654. The study found that foreign ownership had a positive and significant effect on bank profitability ($\beta = 1.947$). This effect was significant at 5% level of confidence. These results mean that higher levels of foreign ownership result in higher bank profitability.

The study sought to determine the relationship between domestic ownership and bank profitability in Kenya. The study also found that the shares owned by domestic investors ranged from a low of 13,452,147 to a high of 75,450,689 with a mean of 48,632,450 and a standard deviation of 14,452,457. From the regression analysis, the results show that domestic ownership had a positive and significant effect on bank profitability ($\beta = 1.175$). This effect was significant at 5% level of confidence. These results mean that higher levels of domestic ownership result in higher bank profitability.

The study sought to determine the relationship between state ownership and bank profitability in Kenya. The study further found that state ownership ranged from a low of 2,540,478 shares to a high of 85,456,812 shares with a mean of 64,321,461 shares and a standard deviation of 10,458,610 shares. The results show that state ownership had a negative and significant effect on bank profitability ($\beta = -0.048$). This effect was significant at 5% level of confidence. What this means is that higher levels of state ownership lead to lower profitability in commercial banks.

The study found that the independent variables had a very high correlation with ROE ($R = 0.976$). The results also show that the variables accounted for 95.3% of the variance in ROE ($R^2 = 0.953$). ANOVA results show that the F statistic was significant at 5% level. Therefore, the model was fit to explain the relationships.

**CONCLUSIONS**

The study found that ownership concentration is negatively correlated with bank profitability. The study concludes that higher ownership concentration leads to lower profitability of commercial banks in Kenya. Therefore, as the number of blockholders rise in a bank, the performance of the bank falls while as the number falls, performance rises. The study found that foreign ownership is positively correlated with bank profitability. The study therefore concludes that higher foreign ownership in a commercial bank leads to higher profitability while lower foreign ownership leads to lower performance in commercial banks in Kenya. The study found that domestic ownership is positively correlated with bank profitability. The study therefore concludes that higher domestic ownership in a commercial bank leads to higher profitability while lower domestic ownership leads to lower performance in commercial banks in Kenya. The study found that state ownership is negatively correlated with bank profitability. The study concludes that higher state ownership leads to lower profitability of commercial banks in Kenya. Therefore, as the ownership of the state rises in commercial banks, the performance of the bank falls while as the ownership falls, performance rises.

**RECOMMENDATIONS**

The study recommends that commercial banks should desist from higher levels of blockholder owners in order to reduce ownership concentration. This will help improve the profitability of commercial banks in Kenya. Secondly, the study recommends that commercial banks should encourage foreign investors to invest in their firms as the higher levels of foreign ownership would lead to better firm profitability. Thirdly, the study recommends that commercial banks should encourage local investors to invest in their firms as the higher levels of local ownership would also lead to better firm profitability. There is
need therefore to balance between local and foreign investors. Lastly, the study recommends that state ownership in commercial banks in Kenya should be reduced. This is because higher levels of state ownership are detrimental to the profitability of banks.

REFERENCES


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