International Journal of Management and Commerce Innovations ISSN 2348-7585 (Online)
Vol. 12, Issue 1, pp: (185-190), Month: April 2024 - September 2024, Available at: www.researchpublish.com

BOARD INDEPENDENCE AND FINANCIAL STABILITY OF SELECTED MICROFINANCE BANKS IN KENYA

[1] Phineas Koome Mbaya, [2]Ambrose Jagongo (PhD), [2]Gerald Atheru

[1]MSc (Finance) Student, Department of Accounting & Finance, School of Business, Economics and Tourism, Kenyatta University, P.O. Box 43844-00100, Nairobi, Kenya

[2&3]Department of Accounting & Finance, School of Business, Economics and Tourism, Kenyatta University, P.O. Box 43844-00100, Nairobi, Kenya

DOI: https://doi.org/10.5281/zenodo.13335513

Published Date: 17-August-2024

Abstract: **This study evaluated the effect of board independence on financial stability of microfinance banks in Kenya. The 14 microfinance banks in Kenya constitute the target population and subsequently sample size based on a census approach. Utilizing quantitative methods, descriptive statistics, and panel data regression analysis, data was analyzed and summarized; result was based on panel data regression analysis. Board independence had a negative and significant effect on financial stability of microfinance banks in Kenya. The study recommends that the central bank of Kenya should develop and enforce specific guidelines or regulations that mandate a minimum level of board independence for microfinance banks.**

Keywords: **Board Independence, Financial Stability, Agency Theory and Financial Intermediation Theory.**

1. INTRODUCTION

1.1 Background of the Study

In accordance with the 2030 Sustainable Development Goals (SDGs), eliminating poverty is the first fundamental goal and necessary condition for sustainable development. According to Abu Wadi, Bashayreh, Khalaf, and Abdelhadi (2002), microfinance institutions (MFIs) are widely viewed as instruments for achieving sustainable growth in developing countries. However, if the MFIs are able to expand their reach and become financially sustainable, this function can only be ensured. The dual goals of MFIs are social mission and financial stability (Tilahun, 2022).

Risks to financial stability have increased as a result of the global financial system's resilience being put to a number of severe tests (Global Financial Stability Report, 2022). Months after worldwide economic downturn ended, players in the market elevated their vulnerability to liquidity, time frame, and risk associated with credit during exceptionally low-interest rates, compacted volatility, and a lot of liquidity, often employing monetary leverage to improve returns weaknesses that were continually observed in earlier problems with Global Financial Stability Report (Financial reports, 2023).

The unexpected collapses of Silicon Valley and Signature Bank in US and decline in confidence in markets in Credit Suisse, a global systemically important bank (GSIB), in Europe have served as a stark instance of difficulties brought on by relationships among more compact economic and banking regulations and accumulation of drawbacks (Global financial stability reports, 2023). This first happened as occurrences in US banking sector suddenly transmission to financial institutions and economies throughout the world, exacerbated by technological advances and the rapid distribution of knowledge via social media, leading to a sell-off of risk assets (International monetary fund, 2023).

Despite the crucial role played by microfinance banks, the narrative of the comparative financial growth as well as inclusivity in Ghana is unable to be recounted. Ghana's microfinance institutions rely heavily on interpersonal connections to provide for their customer base, the majority of whom reside in rural regions (Rowland, Dabi & Maya, 2023). According to Ehugbo (2021), the pattern has increased investors' need to assess a bank's soundness before making an investment to guarantee the capital invested security and the long-term monetary security of the bank in Nigeria. The study also demonstrated that no organization is too large to potentially face a collapse due to corporate and governance issues, which clarifies the recent corporate collapses of some formerly well-known and recognized businesses in Nigeria (Okolie & Uwejeyan, 2022).

Board independence is characterized as the fraction of directors that are non-executive to all other directors in a corporation. It is generally accepted that the more non-executive members make up a board, the more independent its membership becomes (Alabi, Olaoye, & Ojo, 2022). If there are more non-executive members than executive directors on the board, the board is considered to be independent. Principal-agent conflicts are reduced because to improved business oversight, which is the major benefit of board independence (Namanya, Musiime & Muganga, 2021). Therefore, according to the majority of corporate governance laws and best practices, the board must include internal directors (executive members) and non-executive directors (OECD, 2015). Board independence enhances firm oversight as well as supervision, encourages more informed choices and more effective distribution of resources, boosts profitability, as well as has the potential to enhance the financial well-being of the organization (Namanya, Musiime & Muganga, 2021).

The financial stability of Kenyan MFBs has worsened since 2015. A weak executive branch and declining operations may be to blame for this (Ndirangu *et al*., 2022). Three MFBs were able to raise additional funds due to inadequate financial results in comparison to required core capital required by legislation to create microfinance organizations (Kenya Bankers Association [KBA] 2020). Choice MFB also fell short of maintaining acceptable liquidity ratio of 20%. Additionally, it has caused marketing offices and locations to close (Abdelsalam *et al*., 2021).

1.2 Statement of the Problem

The survival of the banking industry and the overall health of the economy are both harmed by sector instability. Due to the high financial costs associated with maintaining despite the banks being in an advantageous position of intermediation, this left them vulnerable to a number of shocks that may cause them to fail and cause other banks to fold (Ahmed *et al.,* 2021). This depletes banks' liquidity, a key component of a healthy financial system without which clients' trust is undermined. Since 2016, these banks' ROA and ROE have been characterized by declining numbers. The potential reduction in financial sustainability is a major concern because of the instability of the banks financially that generates as consequence of increasing banks' balance sheet uncertainties (Kenya Financial Stability Report, 2017). In 2016 February, ROE and ROA were, respectively, 27.3% and 27%. Reports indicated that ROE was 21.2% and ROA was 17.6% in June 2017. MFBs' financial performance has had a shifting tendency over the years. Kenyan microfinance banks lost Ksh 1 billion in total in June 2020, a 30% decline the same year in terms of ROA and ROE, to Ksh 0.7 billion (CBK, 2020).

As an illustration, SMEP Microfinance Banks Limited reported that their net interest margin dropped by 0.22% from 0.24% in 2014 to 0.16% in 2016 with the previous year's reduction being even worse. Additionally, Faulu Microfinance Banks Limited reported that NIM dropped from 0.10% in 2014 to 0.08% in 2018. Additionally, NIM for Kenya Women Microfinance Banks Limited decreased from 0.22% in 2017 to 0.19% in 2019 (AMFI, 2017; 2018; 2019) and Uwezo Microfinance Banks Limited decreased from 0.25% in 2016 to 0.17% in 2018 (AMFI, 2017; 2018; 2019).

Additionally, a limited number of major banks contribute for between 80 and 90 percent of financial viability, with the remaining portion going to medium-sized and small MFBs (CBK, 2017). Notably, microfinance banks have less capacity to withstand large losses and to restructure loans than commercial banks. Therefore, this is of great significance to all parties involved in the financial industry. However, because to the majority of studies' attention being drawn to commercial banks, this area of research has received minimal attention.

Marie, Kamel, and Elbendary (2021) studied internal governance structures and financial stability linkages of Egyptian banks from 2010 to 2019. Khan, Zada, Wong, and Ahmed (2023) investigated impacts of internal corporate governances' practices on risk-weighted capital and commercial banks stability financially that are listed on Pakistan Stock Exchange. These studies were carried out in different countries thereby providing contextual gap. Asare *et al*. (2022) investigated impacts of board sizes on stability and financial performances of African banks, the study showed little significant relationship between variables. Kiptoo, Kariuk and Ocharo (2021) looked at connections between corporate governances and financial success of insurance enterprises in Kenya. Study found significant and positive relationships. Waithigi, Kenyanya, and Oluoch (2022) established impacts of board sizes on financial performances of listed manufacturing enterprises in Kenya as assessed by ROA and Tobin's Q, study found significant relationships. These studies provided conceptual gaps

From the above studies it is evident that studies carried out on board characteristics and financial stability has mixed result and has contextual, conceptual and methodological gaps. This study evaluated board independence effect on financial stability of MFBs in Kenya.

2. THEORETICAL REVIEW

Agency theory was introduced by Jensen and Meckling (1976). It suggests giving the board of management control over daily activities and delegating organization management to them. When assigning tasks or abdicating responsibilities to a third party, managers operate as the agents of the corporation owned by shareholders, who are the principle. Agency expenses might develop as a result of the disparate interests of the constituent parts of a corporation. When anomalous activity occurs, shareholders use monitoring technologies at their own expense to prevent future decline, while management have paid bonding costs to persuade the principals that no harm would result from their actions and choices.

Financial intermediation theory was postulation was developed by Diamond (1984). As contained in the proposition, the role of a financial middleman lowers transaction costs and asymmetries in information. This involves the transfer of cash, in the form of loans with interest clauses, from deficit spenders to surplus spenders. In order to focus on specialized financial goods, banks do financial intermediation, according to Scholtens & Van Wensveen's 2003 study. Market imperfections, without which financial intermediaries wouldn't exist, are what lead to the formation of financial intermediation (Andries, 2009). The disparity in knowledge between suppliers and purchasers hinders many market processes. Financial markets are intrinsically described by information asymmetry, where purchasers or borrowers are more informed than fund lenders about the projects they plan to carry out. In such circumstances, borrowers possess more knowledge about their honesty, assets, and labor than that provided to lending establishments.

2.1 Empirical Review

In their study from the years 2013 to 2018, Kiptoo, Kariuk and Ocharo (2021) explored relationships between corporate governances and monetary success of Kenyan insurance companies. Data was submitted by 51 insurance companies that had license as at 2018 December 31st. Regression analyses of data indicated corporate governances had significant impacts on financial success of insurance organizations. According to the findings, there is substantial and beneficial relationships existence of board independence with performances financially. This suggests that businesses with higher percentages of directors who are autonomous do more than those with smaller percentages. In order to ensure that boards make decisions that are unbiased or independent and enhance financial performances, insurance companies should ensure that boards have sufficient numbers of independent directors. Insurance companies in Kenya were the focus of the prior survey, while the recent study utilized Kenyan microfinance banks. The survey used 2013 to 2018 as scope of the time, this investigation used time period from 2016-2022.

Islam and Islam (2022) looked into how board independence, director ownership, and organizational profitability related to one another. The listed case of non-financial firms on Dhaka Stock Exchange between 2015-2019 is looked at to demonstrate the connections. Generalized method of moments (GMM) econometric method was applied to efficiently address endogeneity concern. Directors' shareholdings positively with substantially impacted on profitability whereas board independence negatively and significantly impacts on the same. Ownership of directors was noted to effectively moderate detrimental impacts of board independence on organizational performances. The study mainly focused on board independence and organizational profitability, this study focused on board characteristics and financial stability where board size, board independence a d board activity are variables. The study utilized director ownership as a moderating variable, this study utilized interest rate as moderating variable.

Ngo, Le, Nguyen, and Luu (2023) analyzed board independence impacts on performances financially of firms listed on stock market of Vietnamese with mediating function of market competition. This research uses Herfindahl-Hirschman index (HHI) to quantify market competitiveness. Following the HHI calculation, the research categorized organizations as operating in either market with intense competition or one with little competition. Secondary information was gathered from financial statements of companies on VSE between 2016-2020. Data analysis strategies were pooled OLS, Fixed and mixed effects model, and GMM. Financial performances of public businesses are negatively impacted by CEO duality, based on GMM results. According to statistical evidence, market competitiveness and non-executive percentages of board influenced financial success favorably. Data likewise demonstrated that market competition can reduce good effects of proportion of members of non-executive on financial success of firms. This study concentrated on board features with board size, independence, and activity as criteria. The earlier research concentrated primarily on board independence. This study was centered on financial stability as opposed to the previous study's concentration on financial performances. This study was conducted in Kenya, while previous one was done in Vietnam.

3. RESEARCH METHODOLOGY

Population, according to Cooper and Schindler (2009), refers to group entirety factors from the researcher's wish for drawing conclusions. Thirteen MFBs in Kenya make up study's target population. The 14 microfinance banks that CBK has licensed and their published financial statements serve as the study's units of analysis and observation, respectively.

Finding a representative of a population for a survey is known as sampling (Cooper & Shindler, 2009). The research, however, used a census approach since it concentrated on all Kenyan microfinance banks that are operational from 2016 up till 2022 which are 14 in number. Additionally, according to Kothari (2011), it improves the authenticity of the data that is gathered.

The researcher collected data from the reports of the microfinance banks where the data was subjected to cleaning to remove errors, inconsistencies, missing values, or outliers that can affect the accuracy of analysis. The data characteristics were explored to gain a preliminary understanding of its characteristics such as mean, standard deviation, minimum and maximum values. Furthermore, the analysis was subjected to diagnostic tests to ensure that none of the regression axiom was violated. More so, the analysis of the data was done using panel regression where the results were presented using tables.

4. RESEARCH FINDINGS AND DISCUSSION

4.1 Descriptive Analysis

The investigation generated a comprehensive array of descriptive statistics for the studied variables, including average score mean, deviations from standard values, lowest and extremes values. These findings are conveniently tabulated in Table 4.1 for further analysis and interpretation.

Table 4.1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Financial Stability	48	1.422292	2.079135	-8.82	7.26
Board Independence	93	3.172043	1.571649	1	7

Source: Study Data (2024)

Examining the descriptive features of the variables, particularly their central tendency and dispersion, the study found that financial stability had a mean score value of 1.4222 and a deviation of 2.0791 from standard. This signifies that microfinance banks exhibited an average financial stability of 1.422%, with individual banks showing varying degrees of stability within the range of -8.82% and 7.26%.

For board independence, the average across banks was 3.17 (mean value of 3.1720), but individual banks exhibited varying degrees of independence within the range of 1 to 7 members, as illustrated by the deviation of 1.5716% from standard.

4.2 Regression Analyses

Utilizing the robust methodology of panel regression analysis, this research sought to evaluate the factors influencing the financial stability of microfinance banks within the Kenyan context. Table 4.2 showcases the regression analysis

Table 4.2: Reegression Results

Financial Stability	Coef.	Robust Std. Err.	z	P>z	[95% Conf.	Interval]
Board Independence	-.1813832	.0880631	-2.06	0.039	-.3539838	-.0087826
_cons	-.6417661	3.79658	-0.17	0.866	-8.082926	6.799394
Wald Chi2 (3)	6.43					
Prob > Chi2	0.0924					
R-Square	0.0494					

Source: Study Data (2024)

Aligned with the primary objective of investigating the effect of board independence on financial stability of Kenyan microfinance banks, this study employed robust statistical methods. The outcomes significantly deviated from the statement of zero-conditioned, revealing a significantly negative effect of board independence on stability financially at a significance level of 0.05 thus directing the null claim rejection. This suggests that board independence is not only relevant, but indirectly contributes to the improved financial stability of these institutions. This outcome can be attributed to the fact that the board members independence is interfered with which does not allow the board members to executed policies and decisions that could lead to the financial stability to the banks in Kenya. The output is constant with Kiptoo, Kariuk and Ocharo (2021) who unfolded that the existence of significant effect of board independence on financial performance. Islam and Islam (2022) also discovered board independence has negative and significant impacts on profitability. Ngo, Le, Nguyen, and Luu (2023) unraveled that financial performances of public businesses are negatively impacted by CEO duality.

5. CONCLUSION

While investigating the potential effect of board independence on financial stability in Kenyan microfinance banks (objective two), the analysis yielded a statistically significant negative effect. Therefore, the survey concluded that board independence is a major determinant of financial stability in Kenyan microfinance banks.

The central banks of Kenya should develop and enforce specific guidelines or regulations that mandate a minimum level of board independence for microfinance banks. This could include setting criteria for the appointment of independent directors, ensuring a balanced representation of stakeholders, and establishing mechanisms to avoid undue influence from shareholders or related parties.

REFERENCES

[1] Abdelsalam, A., Mohammed, A. M. E., Mohamed, Y. A., Barake, S., & Nobanee, H. (2021). The role of the central bank of Kenya in the financial stability. *Journal of Financial Stability*, 54, 100854.

[2] Abu Wadi, R., Bashayreh, A., Khalaf, L., & Abdelhadi, S. (2021). Financial sustainability and outreach in microfinance institutions: Evidence from MENA countries. *Journal of Sustainable Finance & Investment.* Retrieved from https://doi.org/10.1080/20430795.2021.1964814

[3] Araka, H. Otieno. S. & Mogwambo, V. (2021). Effect of interest rate regulation on the relationship between loan lending policies and financial performance of commercial banks in Kenya. *Research Journal of Finance and Accounting*, 12 (4), 50-66.

[4] Alabi, A. W., Olaoye, F. O., & Ojo, O. D. (2022). The nexus between corporate governance and financial performance of the FTSE 100 Index Entities in the United Kingdom. *European Journal of Business and Management Research*, 7(6), 235–246.

[5] Asare, N., Muah, P., Frimpong, G. & Anyass, I.A. (2023). Corporate board structures, financial performance and stability: evidence from banking markets in Africa. *Journal of Money and Business*, 3 (1), 43-59.

[6] Ehugbo, I. (2021). The impact of corporate governance board features on microfinance bank performance in Nigeria. *International Journal of Academic Research in Accounting, Finance and Management Sciences,* 11 (2), 27-46.

[7] International Monetary Fund. (2023). A financial system tested by higher inflation and interest rates. Retrieved from file:///C:/Users/user/Downloads/ch1.pdf

[8] Islam, M. T. & Islam, M. A. (2022). Dynamic association between board independence and firm profitability: The moderating role of director ownership. *Journal of Management and Economic Studies,* 4 (3), 388-389

[9] Kenya Bankers Association. (2020). Kenya bankers association annual report and financial statements 2021. Kenya Bankers Association. Retrieved from Libraryir.parliament.go.ke

[10] Kiptoo, K. I., Kariuki, S. N. & Ocharo, N. K. (2021). Corporate governance and financial performance of insurance firms in Kenya. *Cogent Business & Management*, 8:1, DOI: 10.1080/23311975.2021.1938350

[11] Khan, N., Zada, H., Wong, W. K. & Ahmed, S. (2023). Does internal corporate governance mechanism affect financial stability and risk-weighted capital of banks? Empirical evidence from Pakistan. Retrieved from http://dx. doi.org/10.2139/ssrn.4455185

[12] Marie, M., Kamel, H. & Elbendary, I. (2021). How does internal governance affect banks' financial stability? Empirical evidence from Egypt. *International Journal Disclosure and Governance*, 18, 240–255. https://doi.org/ 10.1057/s41310-021-00110-8

[13] Namanya, D., Musiime, G. & Muganga, C. (2021). Board independence and company performance in East Africa. *Research Journal of Finance and Accounting*, 12 (12), 1-16.

[14] Ndirangu, E. W., Kiragu, D., Ngunyi, A., Shano, M., & Kimani, J. G. (2022). Effect of online banking on performance of microfinance banking in Kenya. Retrieved from http://repository.dkut.ac.ke:8080/xmlui/handle/ 123456789/7884

[15] Ngaira, A. P. & Miroga, J. (2018). Determinants of financial stability of listed commercial banks in Kenya. *The Strategic Journal of Business and Change Management,* 5(4), 1074- 1097.

[16] Ngo, M. T., Le, T. N., Nguyen, N. T. & Luu, T. T. T. (2023). Board independence and financial performance: Empirical evidence on mediating role of market competition from the Vietnamese market. *International Journal of Professional Business Review*, 8 (5), 01-23.

[17] Nyamasege, B. M., Mutswenje V. S. (2023). Firm characteristics and financial performance of selected micro finance banks in Kenya. *International Academic Journal of Economics and Finance*, 3(9), 395-409.

[18] Rowland, S. K., Dabi, N. S. & Maya, S. (2023) Capital structure, financial performance and sustainability of microfinance institutions (MFIs) in Ghana. *Cogent Economics & Financ*e, 11:2, DOI: 10.1080/23322039. 2023.2230013

[19] Okolie, A. O. & Uwejeyan, J. C. (2023). Board Characteristics and Financial Performance of Conglomerates in Nigeria. *European Journal of Business and Management Research*, 7 (2), 12-18.

[20] Ongore, V. O. & Kusa, G. B. (2020). Determinants of Financial Performance of Commercial Banks in Kenya. *International Journal of Economics and Financial*, 3, 237-252.

[21] Oyewobi, I. & Lawal, M. A. (2021). Effect of board size on financial performance of listed deposit money banks in Nigeria. *Bingham International Journal of Accounting and Finance (BIJAF)*, 2 (1), 1-12.

[22] Oyebanji, S. O., Alabi, O. D., Ajiboye, O. A., & Folorunsho, I. T. (2022). Corporate Governance and financial performance of microfinance banks in Nigeria. *Fuoye Journal of Finance and Contemporary Issues*, 3(1), 127-141.

[23] Sanyaolu, W.A., Adejumo, B.T., & Kadiri, I. (2020). Board diligence and financial performance: evidence from Nigerian Deposit Money Banks. *Copernican Journal of Finance & Accounting*, 9(3), 145–160. http://dx.doi.org/ 10.12775/CJFA.2020.017

[24] Tilahun, A. T. (2022) Credit expansion and financial sustainability of microfinance institutions: A generalized method of moments panel data analysis. *Cogent Business & Management*, 9:1, DOI: 10.1080/23311975.2022. 2140490

[25] Titilayo, A., Adediran, S. A., & Achimugu, A. (2022). Board Characteristics and Firm Performance of Quoted Insurance Companies in Nigeria. *International Journal of Public Administration and Management Research*, 7(5), 1-22.