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EFFECT OF CORPORATE GOVERNANCE ON THE FINANCIAL PERFORMANCE OF BANKING INDUSTRY IN RWANDA: (A CASE STUDY-COMMERCIAL BANKS IN RWANDA)

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ABSTRACT: *This study investigated the effect of corporate governance on Financial Performance of commercial banks in Rwanda. The study has four objectives which determined how board size, CEO duality, institutional ownership, board composition affect financial performance of commercial banks in Rwanda. The study adopted a descriptive research design which assisted to examine the effect of corporate governance on financial performance of commercial banks. The population of the study was 120 composed by the senior managers of the commercials banks operating in Rwanda; and the sample size was 92 but only 76 responded to the questions asked which represent 84%.The key findings for this research were showing that board independence, board composition, institution ownership do not have an effect on financial performance since the majority of respondent have disagreed the effect of corporate governance variables on the financial performance of commercial banks. The analysis of variance has shown that corporate governance variables are not significant predictors to explain the increase of profitability represented by return on asset and return on equity since the p value was 0.447 and 0.186 respectively. This research has concluded that there is no effect between corporate governance using board size, board composition CEO duality as well as institutional ownership are not predictors of financial performance and recommended the regulatory body of commercial banks in Rwanda to provide a guidance on the use of corporate governance practices which may impact positively the financial performance of commercial banks*

KEYWORDS: Corporate Governance, Financial Performance, Commercial banks

INTRODUCTION

Background of Study

The concept of corporate governance of banks and very large firms has been a key topic on the policy agenda in developed market economies for 21st century. Besides that, the concept is progressively warming itself as a main concern in the African continent. Indeed, it is believed that the Asian crisis and the relative poor performance of the corporate sector in Africa have made the issue of corporate governance a catchphrase in the development debate (Berglof and Von -Thadden, 1999).

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Corporate governance therefore refers to the procedures and structures by which the business and affairs of institutions are directed and managed, in order to improve long term shareholders‟ value by enhancing corporate performance and accountability, while taking into account the interest of other stakeholders (Jenkinson and Mayer, 1992). Corporate governance is therefore, about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that will foster good corporate performance.

Globalization has continuing speed which makes the financial arena to become more open to new products and services invented. However, financial regulators everywhere scrambles to assess the changes and master the turbulence (Sandeep, Patel and Lilicare, 2002:9).

An international wave of mergers and acquisitions has also swept the banking industry. In line with these changes, the fact remains unchanged that there is the need for countries to have sound resilient banking systems with good corporate governance. This will strengthen and upgrade the institution to survive in an increasingly open environment (Qi, Wu and Zhang, 2000; Köke and Renneboog, 2002 and Kashif, 2008).

Given the fury of activities that have affected the efforts of banks to comply with the various consolidation policies and the antecedents of some operators in the system, there are concerns on the need to strengthen corporate governance in banks. This will boost public confidence and ensure efficient and effective functioning of the banking system (Soludo, 2004). According to Heidi and Marleen (2003:4), banking supervision cannot function well if sound corporate governance is not in place. Consequently, banking supervisors have strong interest in ensuring that there is effective corporate governance at every banking organization. As opined by Mayes, Halme and Aarno (2001), changes in bank ownership during the 1990s and early 2000s substantially altered governance of the world's banking organization. Corporate governance of banks raised very important policy research questions. The crucial question is how these changes affect bank performance. In this research, a researcher focused on finding how the corporate governance components affect the financial performance of banking industry in general

Statement of Problem

The few studies on bank corporate governance narrowly focused on a single aspect of governance, such as the role of directors or of stockholders, while omitting other factors and interactions that may be important within the governance framework.

Feasible among these few studies is the one by Adams and Mehran (2003) for a sample of US companies, where they examined the effects of board size and composition on value. Another weakness is that such research is often limited to the largest, actively traded organizations- many of which show little variation in their ownership, management and board structure and also measure performance as market value.

According to Bairathi, V. (2009). "Corporate governance is not just corporate management; it is something much broader to include a fair, efficient and transparent administration to meet certain well-defined objectives. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting

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environmental and local community needs. When it is practiced under a well-laid out system, it leads to the building of a legal, commercial and institutional framework and demarcates the boundaries within which these functions are performed. “Well-functioning corporate governance mechanisms in developing economies are crucial for both local firms and foreign investors interested in the tremendous opportunities that such economies provide.

In some countries (for example Iran and Kuwait), banks were part of larger family-controlled business groups and are abused as a tool of maximizing the family interests rather than the interests of the stakeholders. In other cases where private ownership concentration was not allowed, the banks were heavily interfered with and controlled by the government even without any ownership share (Williamson, 1970; Zahra, 1996 and Yeung, 2000). Understandably in either case, corporate governance was very poor. The symbiotic relationships between the government or political circle, banks and big businesses also contributed to the maintenance of lax prudential regulation, weak bankruptcy codes and poor corporate governance rules and regulations (Das and Ghosh, 2004; Bai, Liu, Lu, Song and Zhang, 2003).

In Africa corporate governance in many banks failed because boards ignored these practices for reasons including being misled by executive management, participating themselves in obtaining un-secured loans at the expense of depositors and not having the qualifications to enforce good governance on bank management. In addition, the audit process at banks appeared not to have taken fully into account the rapid deterioration of the economy and hence of the need for aggressive provisioning against risk assets

The lack of sufficient research on the effect of corporate governance on the profitability and ignoring the impact of corporate governance practices has pushed a researcher to tackle this topic in order to find out the impact of corporate governance in the banking industry in Rwanda.

Objectives of the Study

The general objective of this study is to assess the effect of corporate governance on financial performance of the banking industry and particularly in commercial banks in Rwanda.

Specific objectives of the Study

Multiple factors representing corporate governance such as board size, Board composition, institutional ownership as well as CEO duality to the other side return on asset and return on Equity will be used as dependent variable. The following objectives will guide this research;

i. To examine the effect of board size on financial performance of commercial banks in Rwanda .

ii. To determine effect of board composition on financial performance of commercial banks.

iii. To investigate effect of CEO duality on financial performance of commercial banks in Rwanda

iv. To determine effect of institutional ownership on financial performance of commercial banks.

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Research questions

i. Is there any significant effect of board size on financial performance of commercial banks in Rwanda?

ii. To what extent board composition affect the financial performance of commercial banks in Rwanda?

iii. Does CEO duality affect financial performance of commercial banks?

iv. To what extent the board ownership affect the financial performance of commercial banks in Rwanda?

RESEARCH METHODOLOGY

Research Design

The researcher used a descriptive research design. Descriptive research seeks to establish factors associated with certain occurrences, outcomes, conditions or types of behavior. This is deemed appropriate because the study involve in depth a study of corporate governance measures and its effect on financial performance of Commercial banks in Rwanda which help the researcher in describing the state of the real effect on its effect. A descriptive study was undertaken in order to certain and be able to describe the characteristics of the variables of interest in a carried out study.

Target population

A researcher use the information from the commercial banks, and target population was the Senior managers in different commercial banks operating in Rwanda; and the total number of target population is 120.

Sampling size

A researcher used a statistical formula. The formula to be used has been perfected by Yemane (1967:886) which provides a simplified formula to calculate sample sizes.

Sample size determination

Researcher selected sample for research using the below Yemane's formula

$$n = \frac{N}{1 + N(e)^2}$$

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N= Population size

n= Sample size

e= standard error

Confidence level 95%, p=0.5

The determination of the simple size was done as follows;

N= 120 and e= 0.05

n= $120/1+120(0.05)^2 = 92$

Based on calculations the formula gave the sample size of 92 respondents, this formula is very accurate to the population which is having a very little number of population.

Data Collection Instruments

Data was collected using different instruments.

Questionnaires distribution/ Collection

This is an important method of data collection. Judd (1991) said that a questionnaire is justifiable in data collection mainly because; it enables the researcher to collect large amount of data within a short time period, it also provides opportunity for respondents to give frank, anonymous answers. One set of questionnaire was designed for the lecturers; it included both open and closed ended set of questions that to be answered. The questionnaire was written in a simple and clear language for the respondent to feel free while answering. In addition to that the use of questionnaire was considered vital to the research since it provides accurate information regarding the study.

Documentary Review

The researcher reviewed literature obtained from the case study organization. The data was collected from sources which already exist about organization and had been used before, for example information from financial statement, journals, books and internet. The researcher collected data from financial statement of the commercial banks to analyses trend of return on assets within the period studied.

Data Management and Analysis

The data collected was processed and analyzed using SPSS software. This involved data coding, editing and tabulation especially quantitative data. The purpose of all these is to make the information clear and understandable for other people. Qualitative and quantitative approach was used for analysis. Mean and standard deviation was used to give a clear understanding of the research interpretations for clear and easy understanding of the phenomenon studied.

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RESULTS AND INTERPRETATION

In analyzing the effect of corporate governance and financial performance of commercial banks in Rwanda, this study made use of primary and secondary data. The study collect primary data concerning corporate governance through open ended and closed questions that has been distributed to the sample size and data drawn from the annual reports of the banks under review. We adopted for the descriptive statistics and regression analysis to find out the effect of the corporate governance using board size, board composition, institutional ownership, and CEO duality on the performance of the commercial banks. However, the analysis of variance was also used to measure the degree of association between variables under consideration.

Board Size

The study sought to establish the effects of board size on the financial performance of Commercial banks in Rwanda.

Table 1: Effect of board size on the financial performance of commercial banks in Rwanda.

	Statement	SA		A		N		D		SD		Total		Mean	std dev.
		Freq	%	Freq	%	Freq	%	Freq	%	Freq	%	N	%		
1	Size of the board increase efficiency of Commercial bank	4	5.26	20	26	0	0	30	39.5	22	29	76	100	2.39	1.297
2	Big size of board increases diversity of opinion affect financial performance	12	15.8	23	30	0	0	37	48.7	4	5.3	76	100	3.03	1.286
3	Big size of board increases competitiveness of board affecting financial performance of the banks	18	23.7	15	20	4	5.3	29	38.2	10	13	76	100	3.03	1.442
4	Big size of the board enhances problem solving which affects financial performance	10	13.2	20	26	3	3.9	30	39.5	13	17	76	100	3.07	1.36

From the table above, 4 (5,26%) and 20 (26%) of the respondents from commercial banks managers strongly agree and agree respectively with the statement says that Size of the board increase efficiency of Commercial banks in Rwanda. On the other hand, 37(39.5%) and 22 (29%) respondents from commercial banks disagree and strongly disagree respectively with the statement the statement says that Size of the board increase efficiency of Commercial banks in Rwanda. Since the majority of respondent have shown that the size of the board does not increase profitability; as it is shown by the mean of 2.39 and the standard deviation of 1.297 we can say that there is no effect of board size on financial performance of commercial banks in Rwanda.

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Also from above table, 12 (15.8%) and 23 (30%) respondents strongly agree and agree respectively with the statement which says thatbig size of board increases diversity of opinion affect financial performance; none of the respondents stood undecided. On the other hand, 37(48.7%) and 4(5.3%) respondents disagrees and strongly disagree respectively with the statement which says thatBig size of board increases diversity of opinion affect financial performance (commercial banks of Rwanda). It's clear that diversity of opinion due to big size does not have any impact on financial performance.

The table above further reveals that, 18(23.7%) and 15(20%) of the respondents strongly agree and agree respectively with the statement which says thatBig size of board increases competition of board affecting financial performance of the commercial banks in Rwanda; 4 (5.3%) stood undecided. On the other hand, 28 (38.2%) and 10 (13%) of the respondents disagree and strongly disagrees with the statement which says that Big size of board increases competition of board affecting financial performance of the commercial banks in Rwanda.

The table above finally reveals that, 10(13.2%) and 20(26%) of the respondents strongly agree and agree respectively with the statement which says thatbig size of the board enhances problem solving affecting financial performance; 3(3.9%) stood undecided. On the other hand, 30 (39.5%) and 13(17%) of the respondents disagree and strongly disagrees with the statement which Big size of the board enhances problem solving affecting financial performance.

Board composition

The study sought to establish the effects of board composition on the financial performance of Commercial banks in Rwanda.

Table 2: Effect of board composition on the financial performance of commercial banks in Rwanda.

	Statement	SA		A		N		D		SD		Total		Mean	std dev.
		Freq	%	Freq	%	Freq	%	Freq	%	Freq	%	N	%		
1	Board composition increases efficiency of commercial banks	2	2.63	15	20	7	9.2	31	40.8	21	28	76	100	2.29	1.153
2	Outside directors are better to challenge and discipline the CEO and management which affecting financial decision and profitability	14	18.4	18	24	4	5.3	19	25	21	28	76	100	2.82	1.512
3	An expatriate CEO has superior knowledge and is likely to improve the performance of commercial banks	26	34.2	7	9.2	0	0	28	36.8	15	20	76	100	3.04	1.628
4	Board composition affect risk management and financial performance	14	18.4	17	22	0	0	14	18.4	31	41	76	100	2.62	1.608

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From the table above, 2 (2.63%) and 15 (20%) of the respondents from commercial banks managers strongly agree and agree respectively with the statement says the board composition increase efficiency of commercial bank7 (9.2%) stood undecided. On the other hand, 31(40.8%) and 21 (28%) respondents from commercial Rwanda disagree and strongly disagree respectively with the statement the statement says that Board composition increase efficiency of commercial banks in Rwanda. The respondents have shown that among the factors that increase profitability board composition does not have any effect on the performance of commercial banks in Rwanda as it is shown by the mean of 2.29 and the standard deviation of 1.153.

Also from above table, 14 (18.4%) and 18 (24%) respondents strongly agree and agree with statement which says that the outside directors are better able to challenge and discipline the CEO and management; 4 (5.3%) stood undecided. On the other hand, 19(25%) and 21(28%) respondents disagrees and strongly disagree respectively with the statement which says that the Outside directors are better able to challenge and discipline the CEO and management.

The table above further reveals that, 26 (34.2%) and 7(9.2%) of the respondents strongly agree and agree respectively with the statement which says that an expatriate CEO has superior knowledge and is likely to improve the performance of commercial banks; none stood undecided. On the other hand, 26 (36.8%) and 15(20%) of the respondents disagree and strongly disagrees with the statement which says that an expatriate CEO has superior knowledge and is likely to improve the performance of commercial banks.

The table above finally reveals that, 14(18.4%) and 17(22%) of the respondents strongly agree and agree respectively with the statement which says that; none stood undecided. On the other hand, 14 (18.4%) and 31(41%) of Board composition affect risk management and financial performance respondents disagree and strongly disagrees with the statement which says that Board composition affect risk management and financial performance.

CEO DUALITY

The study sought to establish the effects of CEO Duality on the financial performance of Commercial banks in Rwanda.

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Table 3: Effect of CEO duality on the financial performance of commercial banks in Rwanda.

	Statement	SA		A		N		D		SD		Total		Mean	std dev.
		Freq	%	Freq	%	Freq	%	Freq	%	Freq	%	N	%		
1	Roles of Chairman of Board and CEO should be clearly defined and not vested in the same person	9	11.8	23	30	0	0	24	31.6	20	26	76	100	3.16	1.609
2	The monitoring role of board is weaker when the CEO is also Chair and affects financial performance of banks	14	18.4	12	16	3	3.9	23	30.3	24	32	76	100	3.59	1.691
3	CEO duality create conflict of interest and it's not good for financial performance of the commercial banks in Rwanda	38	50	12	16	0	0	8	10.5	18	24	76	100	3.63	1.664
4	CEO salary affect financial performance of commercial banks	13	17.1	11	14	1	1.3	26	34.2	25	33	76	100	2.62	1.633

From the table above, 9 (11.8%) and 23 (30%) respondents strongly agree and agree respectively with the assertion that roles of Chairman of Board and CEO should be clearly defined and not vested in the same person; none stand undecided. On the other hand,24 (31.6%) and 20 (26%) respondents disagree and strongly disagree respectively that roles of Chairman of Board and CEO should be clearly defined and not vested in the same person.

Also from the above table, 14(18.4%) and 12(16%) respondents strongly agree and agree respectively that assertion state that the monitoring role of board is weaker when the CEO is also Chair ; 3(3.9%) respondents stood undecided. On the other hand, 23(30.3%) and 24 (32%) respondents disagree and strongly disagree respectively that the monitoring role of board is weaker when the CEO is also Chair. This shows that CEO duality does not have any effect on the performance of commercial banks in Rwanda.

The table above further reveals that, 38(50%) and 12(16%) of the respondents strongly agree and agree respectively with the statement which says thatCEO duality create conflict of interest and it's not good for financial performance of the banks; none stood undecided. On the other hand, 8 (10.5%) and 18(24%) of the respondents disagree and strongly disagrees with the statement which says thatCEO duality create conflict of interest and it's not good for financial performance of the commercial banks in Rwanda,

The table above finally reveals that, 13(17.1%) and 11(14%) of the respondents strongly agree and agree respectively with the statement which says thatCEO salary affect financial performance of commercial banks in Rwanda; 1(1.3%) stood undecided. On the other hand, 26

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(34.2%) and 25(33%) of Board composition affect risk management and financial performance respondents disagree and strongly disagrees with the statement which says that CEO salary affect financial performance of commercial banks in Rwanda**.**

Institutional Ownership

The study sought to establish the effects of institutional ownership on the financial performance of Commercial banks in Rwanda.

Table 4 Effect of institutional ownership on the financial performance of commercial banks in Rwanda.

	Statement	SA		A		N		D		SD		Total		Mean	std dev.
		Freq	%	Freq	%	Freq	%	Freq	%	Freq	%	N	%		
1	High pourcentage of shares hold by internal directors affect the financial performance of commercial banks	17	22.4	15	20	8	11	26	34.2	10	13	76	100	3.04	1.409
2	having high shares hold by internal directors gives power to the decision making in the board meeting	20	26.3	16	21	0	0	24	31.6	16	21	76	100	3	1.566
3	Increase the Value of a share affect the the finances of the banks	19	25	12	16	4	5.3	20	26.3	21	28	76	100	2.97	1.6
4	Financial performance is related to the shares sold by the company every year	16	21.1	15	20	0	0	21	27.6	24	32	76	100	2.72	1.605

From the table above, 17 (22.4%) and 15 (20%) respondents strongly agree and agree respectively with the assertion that high percentage of shares hold by internal directors affect the financial performance of commercial banks; 8(11%) stand undecided. On the other hand,26 (34.2%) and 10 (13%) respondents disagree and strongly disagree respectively that High percentage of shares hold by internal directors affect the financial performance of commercial banks in Rwanda.

Also from the above table, 20(26.3%) and 16(21%) respondents strongly agree and agree respectively that assertion state that the monitoring ;having high shares hold by internal directors gives power to the decision making in the board meeting, none respondents stood undecided. On the other hand, 24(31.6%) and 16 (21%) respondents disagree and strongly disagree respectively that having high shares hold by internal directors gives power to the decision making in the board meeting . This shows that CEO duality does not have any effect on the performance of commercial banks in Rwanda. The table above further reveals that, 19(25%) and 12(16%) of the

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respondents strongly agree and agree respectively with the statement which says thatIncrease the Value of a share affect the finances of the banks; 4(5.3%) stood undecided. On the other hand, 20 (26.3%) and 21(28%) of the respondents disagree and strongly disagrees with the statement which says that Increase the Value of a share affect the finances of the commercial banks

The table above finally reveals that, 16(21.1%) and 15(20%) of the respondents strongly agree and agree respectively with the statement which says thatCEO salary affect financial performance of commercial banks; none stood undecided. On the other hand, 21 (27.6%) and 24(32%) of Board composition affect risk management and financial performance respondents disagree and strongly disagrees with the statement which says that CEO salary affect financial performance of commercial banks**.** Based on the responses given by the respondents it's clear that the majority have confirmed that there is no effect of institutional ownership on financial performance.

Analysis of Variance

Table 7.1: Analysis of Variance - ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	5.960	4	1.490	0.939	0.447
Residual	112,711	71	1.587		
Total	118,671	75			

The F value produces a p-value of 0.447 which is significantly different from zero. A p-value of 0.447 is greater that the set level of significance of 0.05 (5%) for a normally distributed data. This means that the model is not significant in explaining performance of the 12 commercial banks in Rwanda. This calls for a further study which can include other determinants of financial performance. There is no association between corporate governance and return equity.

Table 7.2: Analysis of Variance - ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	5.517	4	1.379	1.593	0.186
Residual	61.470	71	0.866		
Total	66.987	75			

The F value produces a p-value of 0.186 which is significantly different from zero. A p-value of 0.186 is greater that the set level of significance of 0.05 (5%) for a normally distributed data. This means that the model is not significant in explaining performance of the 12 commercial banks. This calls for a further study which can include other determinants of financial performance. This shows that there is no association between corporate governance and return on assets.

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Summary and Discussion of Results

The main objective of this study was to establish whether corporate governance has an effect on Financial Performance of commercial in Rwanda. Corporate governance is set of relationships between a company's management, its board, its shareholders and other stakeholders which provide the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. The study has been based on the four independent variables which are CEO duality, board composition, board size as well as institutional ownership. Financial Performance was measured by the Return on Assets and return on equity of each commercial banks. The first objective was to establish how board size had an effect with profitability of financial performance of commercial banks in Rwanda. The study finds a non-effect of board size and profitability of commercial banks in Rwanda as shown by respondent where 39.5% and 29% disagreed and strongly its effect respectively. These findings corroborate the results of a study done by Yermack (1996), Eisenberg, Sundgren and Wells (1998), Conyon and Peck (1998) and Loderer and Peyer (2002). They have reported a significant negative relationship between board size and the performance of a firm.

The second objective was to establish whether the board composition affect the profitability of commercial banks in Rwanda. Board composition had a negative effect as it was shown by respondent where 31(40.8%) and 21 (28%) respondents from commercial banks disagree and strongly disagree respectively effect of board composition on financial performance with commercial banks. These findings agree with Fosberg (1989) and Molz (1988) who did not find any link between board composition and financial performance.

The third objective of the study was to test how the institutional ownership affect financial performance of the commercial banks. In terms of respondent's frequency, it was found that institutional ownership was not a significant factor in explaining profitability. These findings are inconsistent with a study that was done by Loderer and Peyer, (2002) on institutional ownership effect on firm performance where they found a positive relation between director equity interest and firm performance.

The fourth objective of the study was to test how CEO duality affects financial performance of commercial banks in Rwanda, it was found that CEO duality has no effect on financial performance of commercial banks in Rwanda since the majority of respondents representing 34.2% have disagreed with the statement says that the higher the shares distributed to internal directors the greater the financial performance of the banks. These findings are consistent with the study done by Daily and Dalton (1992) find no relationship between CEO duality and firm performance.

According to the analysis of variance between corporate governance variance and return on assets and return on equity, the study found that board size, board composition, institutional ownership and CEO duality do not have effect on the return on assets and return on equity since p- value was greater than 0.05 where they were 0.447 and 0.186 respectively.

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CONCLUSION AND RECOMMENDATIONS

We therefore conclude that there is a negative effect of board size, board composition, institutional ownership and CEO duality on financial performance of commercial banks in Rwanda. Board size does not explain the profitability due to the fact that the commercial banks in Rwanda are dominated by a large number of members; this implies that most of board membership is there to search for their own interest instead of searching for the interest of commercial bank which is supported by the agency theory. Board composition has shown that it does not explain profitability. This may explained by the fact that the commercial banks in Rwanda the board has a big number of internal directors who are considered as board members. The lower the number of non -executive directors affects negatively the financial performance of commercial banks generally. Non effect of institutional ownership and Financial Performance of commercial banks may partly be due to the fact that shares are considered by board members as a wealth by which everyone is looking for it. Holding a lot of shares by internal directors will maximize individual profit but not company profit maximization. CEO duality do not have effect on the performance of commercial banks in Rwanda this may be explained by the fact that most of the time in our commercial banks you find that there is a clear separation of duties but still this statement does not guarantee the financial performance of commercial banks. Based on this, the paper recommends that regulatory body of the banks should to set up policy which shows clearly how corporate practices may be applied to the commercial banks in order to achieve profitability

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