Institutional Ownership and Commercial Banks Performance in Kenya: is there a Relationship?

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Abstract
Institutional ownership of commercial banks is of great importance given that it as an internal corporate governance mechanism. Different levels of institutional ownership in firms as revealed by recent studies indicate significance differences in their monitoring capability that subsequently impact on performance. Institution ownership, such as those made through pension funds and insurance companies play a critical role in influencing the firm's performance, owing to the knowledge and experience they posses. This study sought to ascertain the relationship between institutional ownership and performance of commercial banks in Kenya that are licensed as companies under the Company Act Cap 486 and as banks under the Banking Act Cap 488. A survey was undertaken on 43 commercial banks that were operational between year 2001 and 2013. Bank performance was defined by three performance indicators namely: return on asset, return on equity and Tobin's Q ratio whereas bank size was adopted as a moderating variable. Secondary data was collected from: annual financial reports, The Kenya Banking Survey 2013, Central Bank of Kenya bank's annual supervisory reports, commercial banks websites, Central Bank of Kenya website, Bankscope, and annual returns filed by banks found at the Registrar of companies at the Attorney General Chambers Nairobi and returns filled at The Nairobi Security Exchange by listed banks. The data collected was analyzed using both descriptive statistics and inferential statistics where hierarchical regression under the panel data framework with the help of SPSS version 21.0 software was used. The findings of the study indicated that there is no relationship between institutional ownership and performance of commercial banks in Kenya when ROE, ROA and TBQ were used as performance measures and that bank size ha a moderating effect in this relationship.

Keywords and Abbreviations: Institutional ownership, corporate governance, Central Bank of Kenya, institutional investors ,firm performance

V.I.F.-Variance inflation factor, ROA-Return on asset, ROE-Return on equity, TBQ-Tobin's Q ratioCBK- Central Bank of Kenya, CEO- Chief Executive officer.

1. Introduction
Davis & Steil, (2001) define Institutional investors as specialized financial institutions, which manage savings on behalf of other investors with a view of attaining a specific objective in terms of acceptable risk, maximization of returns and maturity of claims. Institutional investors take the form of: banks, insurance companies, pension funds and investment funds. Under normal circumstances, institutional investors tend to invest in large volumes. Due to the high stakes they hold, they are able to exercise controls on the action of the management making them be in tandem with the shareholder wealth maximization objective. Seifer *et al.* (2005) using samples of firms from United States, United Kingdom, Germany, and Japan find a significant relationship between institutional ownership and firms performance in these countries. It is widely acknowledged that institutional investors holders posses the capability of boosting market performance by offering high level financing, experience and knowledge to the market in which they have invested (Gurunlu and Gursoy 2010).

As the size of institutional investors grows; so does the potential for improved control over companies in which they hold stocks and hence reduced effects of adverse incentive problems. Institutional investors are known not to move into and out of the firm without influencing the share price. Hirschman, (1970) identified the exercise of powers of institutional investors within an 'exit and voice' framework. He argued that the dissatisfaction of institutional investors may be expressed directly to the management through voicing of concerns at hand (the voice option) or by selling their shares held (the exit option). However, the exit option has been found not to be

the most viable option to many institutional investors in view of the size of their holding. Quick exit may lead to depressed share price resulting from increased supply of such stocks onto the market which on overall may significantly erode shareholders wealth. In view of the above, institutional investors are forced to provide an extra eye in monitoring the operations of the firm by focusing on annual financial reports especially the profit and loss statement. Elyasiani & Jia (2008) find that institutional ownership has a significant positive impact on the performance of banks. Therefore it is expected that institutional share ownership should have a positive relationship with performance of the commercial banks. The question that ought to be answered is whether there is a relationship between institutional ownership and firm performance by specifically focusing on the Kenyan commercial banking sector using the three performance indicators namely: ROA, ROE and TBQ ratio.

2. Review of related literature

Institutional investors are considered to be major players in many financial institutions and markets. Their influence on corporate performance has increasingly been noticed as a result of adoption of structural transformation programs. The structural transformation programs mainly focus on the privatization policy that has been adopted by many developing countries Kenya included. One can argue that the major players in many of the privatization processes that are taking place through capital markets and financial institutions all over the world over are institutional investors. Studies on the relationship between institutional ownership and firm performance provide mixed findings. There are findings to the effect that there is a positive relationship between institutional ownership and firm performance, some find a negative relationship and some do not find any relationship at all.

McConnell & Servaes (1990) in a study of the relationship between institutional ownership and firm performance using a cross-sectional sample of 1173 and 1093 firms listed on the New York stock exchange in 1976 and 1986, respectively find a strong positive relationship between the percentage of shares held by institutional investors and Tobin's Q. They attribute this to the efficient monitoring role played. These findings are supported by Chaganti &Damanpour (1991) and Han & Suk (1998) who find a positive relationship between institutional ownership and firm performance that they attribute to improved efficient monitoring. Chung *et al*. (2002) find that large institutional shareholdings deter managers of a firm from pursuing opportunistic earnings management through discretionary accrual choices that negatively impact on performance. However, it should be noted that given the enormous costs required for monitoring, monitoring activities are left to large institutional investors who have the financial muscle and hold high stake of wealth in firms. Since the share holding of institutional investors is higher than those of the board of directors, institutional investors are known to possess a greater incentive to monitor managers than members of the board (Shleifer and Vishny 1986).

Clay (2001) finds a positive impact of institutional ownership on firm performance to the effect that 1% increase in institutional ownership enhances firm performance by 0.75%. They attribute this to the expectation that institutional investors would reduce the principal-agent problem between managers and shareholders, which in turn would lower the incentives and opportunities for managers to control earnings while raising the effectiveness of the management and the performance of the firm. In the same context, the corporate governance proposals sponsored by institutional investors receive more favorable attention than those sponsored by independent individuals (Gillan and Starks (2000). Barclay &Holderness (1990) and Mikkelson & Ruback (1991) find that institutional investors can force value maximization in firms which definitely impacts on firm performance. In a study of firms facing control problems, it was found that on average an institutional investor was more likely to vote out a non-performing CEO and would participate in making other decisions of the firm than a non-institution investor (Brickley *et al*.,1988). Baysinger & Butler (1985) and Hansen & Hill (1991) find that the level of institutional ownership in a firm is associated with increased research and development expenditures that positively impact on performance by way of reduced cost of doing business and increased productivity.

Foster & Viswanathan (1996) and Back *et al.,*(1999) find that information on firms is revealed more rapidly when there are greater numbers of institutional investors. In support of the above findings the signaling theory proposes that institutional investors have the potential of providing a credible mechanism for sharing information among other investors. This is due to information differences that exist between outsiders and insiders in a firm. Outsiders may possess superior information compared to insiders. The above information gap implies that the firm has the capability of providing signals about its performance to the market and investors. Signaling theory assumes that investors can discern information regarding the future prospects of the firm. Such information may take the form of: leverage, ownership changes or dividend announcements.

Poudel & Hovey (2012) and Bino & Tomar (2007) all agree in their studies that; there is a positive relationship between institutional ownership and bank performance. These findings are in line with those of Mikkelson &

Ruback, (1985), Le *et al.,* (2006) and Ramzi, (2008), who all agree on the important role of institutional shareholders in monitoring the performance of the firm. However, there are related findings to the effect that when institutional investors hold relatively few shares they can easily liquidate their investments if the firm performs poorly, and therefore will have less incentive to monitor it. Under such circumstances, the goal of maintaining the liquidity of their holdings and their desire for short-term profit outweighs the benefits of monitoring the management in the hope of improving the long-term performance of the firm. But if the shareholdings by institutions are high and the shares held are less marketable, the longer the period such shares will be held the greater will be the incentive of institutional investors to monitor the management [(Bhide,1994; Demirag, 1998; Maug, 1998)].

Recent studies point to the fact that institutional investors posses differing characteristics [Pound (1988), Hartzell and Starks (2002) and Parrino *et al.,* (2003)]. Some institutional investors have either existing or potential business relationships with firms in which they hold shares. For such investors to protect those relationships they may be less willing to vote against the decision brought forward by the management. The second type of institutional investors relates to those who do not hold business relationships with the firms in which they hold equity stakes. Based on the above characteristics, Brickley *et al,.* (1988) and Kochhar & David (1996), classify institutional investors into two major categories: pressure-resistant investors and pressure-sensitive investors. Pressure-resistant institutional investors refer to those institutional investors who only have an investment relationships with firms in which they hold equity stakes e.g. pension funds, mutual funds, endowments and foundations. Pressure-sensitive institutional investors on the other hand refer to those institutional investors who are likely to have both investment and business relationships with the firms in which they hold equity stake. They include insurance companies, banks, and non-bank trusts.

Pound (1988) postulates two hypotheses which suggest that a negative relationship exists between institutional ownership and firm value and performance thereof. These are: the conflict-of-interest hypothesis and the strategic-alignment hypothesis. The conflict-of-interest hypothesis asserts that due business relationships with the firm in which they hold equity stakes, pressure sensitive institutional investors are forced to vote in line with the management since voting against management might negatively affect their business relationships. Heard &Sherman (1987) further argues that the investment and business relationships held by institutional investors could create a conflict of interest between institutional investors and the management since the power gained from their ownership stake may be tampered by their reliance on the firm for business activity. Therefore it is more likely that there will be a negative relationship between the high presence of pressure-sensitive institutional investors and firm performance and it is expected that there will be a positive relationship between the high presence of pressure-resistant institutional holders and firm performance. From the on-going it is expected that since pressure-resistant investors have no business relationships with a firm they should be able to monitor the firm better based on the strategic alliance hypothesis.

Woidtke (2002), finds a negative relationship between activist public pension fund ownership and Tobin's Q but a positive relationship between Tobin's Q and private pension funds. The positive relationship between private pension funds and TBQ ratio is attributed to the fact that: private pension funds have large amounts of money to invest for a longer period of time. These moneys are not invested in a small amount of firms because such moves would involve taking unnecessarily high risk. This makes institutional investors not to optimally diversify their portfolio. Thus institutional investors are only willing to hold a large stake in a firm for two reasons: to exercise the private benefits of control and have almost full control in the firm and secondly to ensure that the costs and the extra risk that comes along with the large holdings do not override the benefits (Holderness 2003).

Conversely, Denis & Denis, (1995), find that top management turnover is likely to be high in the presence of high ownership by financial institutions which may negatively impact on firm performance. This is due to the absence of memory on some important aspects of the firm that could foster performance resulting from high management turnover. These findings are in line with those of Htay, (2012) and Mohammad & Shahid, (2012) that there is a negative relationship between institutional ownership and performance of banks. However, finds no relationship between institutional ownership and banks performance. Agrawal & Knoeber (1996), Karpoff *et al.* (1996), Duggal & Millar (1999), Faccio & Lasfer (2000) and Enobakhare, (2010) find no significant relationship between institutional ownership and firm performance making it not clear as to whether institutional investor stock ownership impacts on firm performance.

3. Research Methodology

A survey was conducted on the 43 commercial banks operating in Kenya between 2001 and 2013. The data collected was analyzed using descriptive and hierarchical multiple regression under the panel data framework.

77% of the banks participated in the study. This rate of participants was rated good given that the data obtained was capable of enabling the researchers arrive at a satisfactory conclusion (Mugenda and Mugenda, 2003).

Hierarchical multiple regression was performed to ascertain the relationship between institutional ownership and performance of commercial banks in Kenya as used in the related study Matanda *et al*,(2015) that was of the form:

$Y_{it} = \beta_o + \beta_1 X_{1it} + \beta_2 X_{2it}$

$Y_{it} = \beta_o + \beta_1 X_{1it} + \beta_2 X_{2it} + \varepsilon_{it}$

Where:

Y_{it} -Is bank performance measured by Return on assets, Return on Equity and Tobin's Q ratio.

Subscripts *i* and *t* represent firm and time period, respectively.

β_o- intercept

X_1- Institutional ownership:

X_2- Control variable bank size measured by log of total assets.

ε_{it} -error term

Dependent variables and their measurement

Return on asset, return on equity and Tobin's Q ratio were designated as dependent variables, institutional ownership as an independent variable and bank size as a moderating variable as used in a related study (Matanda *et al* 2015).

Return on Assets is a purely an accounting-based measure computed from the banks financial statement data (CBK 2001-2013). It is the ratio of annual profit before tax to the total assets i.e.

$$ROA = \frac{\text{Profit before tax}}{\text{Total assets}}$$

A higher ROA indicates that the banks management is able to generate income by utilizing the assets at its disposal.

Return on Equity (ROE) is an indicator of how effective the management team in a company is converting the reinvested money into profits. It is the ratio of profit after tax to shareholders equity i.e.

$$ROE = \frac{\text{Net income (Profit after tax)}}{\text{Shareholders' equity}}$$

A higher ROE indicates that the banks ability to generate cash internally.

Tobin's Q ratio (TOBQ) is the ratio of market value of equity to the net worth of the firm.

$$\text{Tobin's Q (TOBQ)} = \frac{\text{Market value of Equity}}{\text{Net worth of the bank}}$$

Where market value of equity is the difference between the market value of the bank and the value of debt and net worth is the amount by which the bank's assets exceed liabilities. If the calculated Q ratio for the bank is greater than 1, there is a strong incentive for investment, that is to say, presence of valuable growth opportunities for the bank or the bank is earning a rate of return that is larger than the its replacement cost. Since it is expressed as the bank's market value to its replacement value, TBQ ratio decreases over time as more participants are enticed to set up more banks leading to a reduction in firm value.TBQ ratio has extensively been used by academic researchers and it stands out as one of the best measures of the market performance of the firm.

For unquoted banks the the estimated market value of equity was calculated using the formula:

$$\text{Estimated value of equity of unquoted bank} = \text{Current price of quoted bank} \times \frac{\text{Own funds (of unquoted bank.)}}{\text{Own funds (of quoted bank.)}}$$

The estimated market value of equity of the unquoted bank was based on the assumption that the unquoted bank possessed characteristics that were similar or almost similar to the quoted bank in terms of share holders' equity

taking both the numerator and the denominator measures were taken at the same date. The estimated market value of the unquoted bank was thereafter divided with the net worth of the bank to arrive at the TBQ ratio.

4. Findings

Table 1 Descriptive statistics

Pariculars	N	Minimum	Maximum	Mean	Std Deviation
ROA	416	-.13	.37	.0257	.03829
ROE	416	-.67	1.25	.1244	.14974
TBQ ratio	416	.00	9.13	.9387	.14218
Bank size	416	2.88	5.51	4.1179	.60476
Institutional ownership	416	.00	.59	.1998	.16402

The table 1 above provides descriptive statistical results on the dependent, independent and moderating variables that were used in the empirical analysis of this study. The findings indicate that on average institutional ownership in the Kenyan commercial banks is 19.98% with a maximum of 59% that deviated by 16.402% on both sides of the mean. This invariably means that institutional investors on average control slightly close to a fifth of ownership stake in the Kenyan commercial banking sector with the remaining stake being held by block holders and private individuals. The average size of commercial banks in Kenya in terms of assets during the period of study was Kshs 13,119million, with the biggest bank holding an asset base of Kshs 323,594 million and the smallest bank holding assets worth Kshs 759 million that deviated by Kshs. 4.03 million on both sides of the mean. From the annual financial reports of commercial banks in Kenya, it can be it is revealed that between 2008 and 2013, 54.83 % of the market share was controlled by six banks leaving 45.17% to 37 banks. From the above it can be concluded that the size of the bank is critical in enhancing the corporate governance mechanisms.

The average ROA, ROE and TBQ ratio that are: accounting, financial and marketing indicators of performance were: 2.57%, 12.44% and .93.87%; with a maximum of 37%, 125% and 913% that deviated by 3.829%, 14.974% and 14.218% on both sides of the mean respectively. The lowest ROA, ROE and TBQ ratio earned during the period of the study were: -13%, -67% and 0% respectively. The low average ROE of 12.44% indicates that the management of commercial banks in Kenya were not effective in utilizing shareholders funds in generating profits whereas the low average ROA of 2.57% indicates that the management of these banks were not efficiently utilizing the assets at their disposal to generate. The minimum TBQ ratio of 0% indicated that some banks earnings were not anywhere near their replacement cost. However, the average TBQ ratio of .9387 closer to 1 indicated that commercial banks in Kenya were earning a rate of return that was closer to their replacement costs. The maximum TBQ ratio of 9.13 and an average of .9387 that is closer to 1 is a signal of better future performance. This may help explain why Kenya has a big number of banks in comparison to its size of the economy. These banks generate and further expect to generate returns greater than their replacement costs given that TBQ ratio is a forward-looking market measure of performance. The Q ratios from the analysis provide promising prospects. The presence of low ROA and ROE and a slightly closer to 1 TBQ ratio in this sector, has made the regulator (CBK) come up with the various prudential regulations on corporate governance (2001,2006 and 2013) that are geared at streamlining and controlling the activities of these institutions and hence protect shareholders interests.

4.2 Hierarchical Multiple Regression

Hierarchical regression multiple regression analysis of the model that is below below was adopted in the analysis:

Performance $(ROA)_{it} = f(\beta_1 X_{1it}, \beta_2 X_{2it,})$ .... (1)

Performance $(ROA)_{it} = \beta_o + \beta_1 X_{1it} + \beta_2 X_{2it.}$ .... (2)

Where: ROA is return on asset.

       i and t are firm and time period respectively.

The support for hierarchical regression was based on the expectation that there would be statistical significance for the addition of the control variable in the second step. The interpretation was based on the variable entered in the second step not withstanding whether or not the variables entered in the previous step were statistically significant. Two null hypotheses were tested:

Ho$_1$ The R^2 change in the relationship between institutional ownership and commercial bank performance in Kenya was equal to zero.

Ho$_2$ Bank size does not reduce the error in predicting the performance of commercial banks in Kenya.

Table 1.Model summary[c]

Performance indicator	Model	R	R^2	Adjusted R^2	R^2 change	F change	Df1	Df2	Sig. F change
ROA[c]	1	.009[a]	.000	-.002	.000	.033	1	414	.857
	2	.265[b]	.070	.066	.070	31.148	1	413	.000
ROE[c]	1	.020[a]	.000	-.002	.000	.158	1	414	.691
	2	.409[b]	.167	.163	.167	82.801	1	413	.000
TBQ ratio[c]	1	.019[a]	.000	-.002	.000	.150	1	414	.699
	2	.563[b]	.317	.314	.317	191.401	1	413	.000

a. Predictors: (Constant) Institutional ownership,

b. Predictors: (Constant) Institutional ownership, Bank size.

c. Dependent variables: ROA, ROE, TBQ ratio.

From table 1 ROA, ROE and TBQ ratio were adopted as dependent variables, institutional ownership as an independent variable and bank size as a moderating variable of bank specific characteristics. From the analysis it is revealed that the three performance measures were not able to explain the variance in the models and were not significant (Sig. F change >.05) in the first step. F(1,414)=.857; P>.05 for ROA, F(1,414)= .691;P>05 and for TBQ ratio (1,414)= .699; P>.05. However, when bank size was introduced in model 2 as a moderating variable the variance in ROA was explained by 7% by the model as a whole. Since the probability of the F statistic P=.000 was less than the level of significance (.05) the null hypothesis that change in R^2 was equal to zero was rejected and the hypothesis that bank size as a control variable reduced the error in predicting bank performance when ROA was adopted as a performance indicator was supported. The introduction of bank size as a control variable explained an additional 7.0% variance in ROA (R^2 change=.070); F(1,413)=31.148; P>.000.Using ROE as a performance indicator in model 2, upon introduction of bank size as a control variable the regression results indicate that the variance in the ROE of commercial banks in Kenya was explained 16.7% by the model as a whole. Since the probability of the F statistic P=.000 was less than .05, the null hypothesis that change in R^2 was equal to zero was rejected and the hypothesis that bank size as a control variable reduced the error in predicting the ROE of commercial banks in Kenya was supported. Introduction of bank size as a control variable explained an additional 16.7% variance in ROE (R^2=.167).When TBQ ratio was adopted as a performance measure in the relationship between institutional ownership and TBQ ratio in model 2, it will be noted that when bank size was introduced as a control variable, the results from the regression model indicate that the variance in TBQ ratio of commercial banks in Kenya was explained by 31.7% by the entire model. Introduction of bank size as a control variable explained an additional 31.7% variance in ROE (R^2=.317).The probability of the F statistic P=.000 that was significant at 5% level. From these findings the null hypothesis that R^2 was equal to zero was rejected and the hypothesis that bank size reduces the error in predicting TBQ ratio was supported.

Table 3 Coefficients[c]

Performance Indicator	Model	Independent Variables	B	Std Error	Beta	t	Sig.	Tolerance	V.I.F.
ROA[c]	1	Constant	.025	.003		8.927	.000		
		Institutional ownership	.002	.010	.009	.180	.857	1.000	1.000
	2	Constant	-.044	.013		-3.448	.001		
		Institutional ownership	.001	.009	.004	.090	.909	1.000	1.000
		Bank size	.017	.003	.264	5.581	.000	1.000	1.000
ROE[c]	1	Constant	.128	.011		11.530	.000		
		Institutional ownership	-.015	.038	-.020	-.397	.691	1.000	1.000
	2	Constant	-.288	.047		-.6.154	.000		
		Institutional ownership	.021	.035	-.027	-.592	.554	1.000	1.000
		Bank size	.101	.011	.409	9.100	.000	1.000	1.000
TBQ ratio[c]	1	Constant	.908	.105		8.646	.000		
		Institutional ownership	.139	.359	.019	.387	.699	1.000	1.000
	2	Constant	-4.520	.402		-11.247	.000		
		Institutional ownership	.068	.297	-.014	.009	.228	1.000	1.000
		Bank size	1.322	.096	.563	13.835	.000	1.000	1.000

c. Dependent variables: ROA, ROE TBQ ratio

Table 3 presents further results of hierarchical multiple regression analysis that demonstrate the relationship between institutional ownership and accounting-based performance indicators ROA, financial accounting measure; ROE and the market measure of performance TBQ ratio of commercial banks in Kenya while moderating for bank size. In model 2 (Table 3) all the three performance indicators (ROA, ROE and TBQ ratio) were found not to be significant in explaining the relationship between institutional ownership and performance of commercial banks in Kenya. It is only the control variable (bank size) that was found to be significant when all the three performance indicators were used. This invariably means that bank size has a moderating effect. It is worth noting that the data used in the analysis (Table 3) does not indicate any multicolinearity problem. Multicolinearity only becomes of concern when the Variance inflation factor (V.I.F.) is greater than 10 Myers, (1990) and when tolerance is less than 0.2 (Menard, 1995).

The above findings are in line with those of Pound (1988) where one may draw conclusions to the effect that institutional investors in the Kenyan banking sector may be characterized as pressure sensitive investors who may not pay a lot close attention in monitoring commercial banks performance since they enjoy some business relationship with some of these banks. These findings are supported by: Craswell *et al*.(1997) who find no significant correlation between institutional ownership and firm performance, Loderer & Martin (1997) who find no significant relationship between institutional ownership and firm performance and Agrawal & Knoeber (1996) who find no significant association between institutional ownership and firm performance based on a list of 383 firms they studied.

5. Conclusion
The results presented in the study confirm the relationship between institutional ownership and performance of commercial banks in Kenya. Most of the institutional investors in Kenya are known to have business relationship with the commercial banks in which they hold ownership stake. In view of this, they may not effectively monitor the performance of these banks lest they risk damaging the business relationship that they enjoy. Institutional investors are known to be cost-efficient rather than engage themselves in monitoring activities of the firm they are interested in short term returns even if such are temporal in nature which may be at the detriment of the bank.

From the findings it can be realized that the effect of institutional ownership on the performance of commercial banks in Kenya still remains an empirical question that call for further research.

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