

FACTORS INFLUENCING THE PERFORMANCE OF THE CAPITAL MARKETS IN KENYA**Helen Wangechi Gikonyo-Mukoko**Jomo Kenyatta University of Agriculture and
Technology**Dr. Karanja Ngugi**Jomo Kenyatta University of Agriculture and
Technology

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ABSTRACT

The capital market plays a significant role in the national economy. A developed, dynamic and vibrant capital market can contribute significantly in the economic growth and development. It mobilizes funds from people for further investments in the productive channels of an economy, activating idle monetary resources and putting them in proper investments. Capital market also helps in capital formation. Through mobilization of ideal resources it generates savings; the mobilized savings are made available to various segments such as agriculture, industry, etc. This raises resources for longer periods of time. Thus it provides an investment avenue for people who wish to invest resources for a longer period of time. The study sought to investigate the factors influencing the performance of capital markets. The study was carried out in Nairobi and target population included Nairobi Securities Exchange (NSE) member firms, Capital Markets Authority (CMA) and listed firms. This study focused on these groups as they are the core functional players in the capital markets. This was descriptive study that utilized a descriptive survey approach; the data obtained was coded using numerals in order to put them in limited number of categories. The study revealed a positive correlation between Policies and regulations of CMA and corporate governance. Incentives to Chief Executive Officers (CEOs) and portfolio diversification were also positively correlated. The findings further indicated negative correlation between Policies and Regulations of CMA and the performance of capital. However, the findings revealed that portfolio diversification and corporate governance are positively correlated. The study also found that when the Policies and Regulations of CMA increase the corporate governance and thus performance improves.

Key words: market, performance, investment

Introduction

Capital markets in the world individually and collectively play a critical role in the most national economies. The markets perform a wide range of economic and political functions while offering trading, investment, speculation, hedging, and arbitrage opportunities. In addition they serve as a

mechanism for price discovery and information dissemination while providing vehicles for raising finances for companies. Capital markets are used to implement privatization programs, and they often play an important role in the development of emerging economies (Lee, Ng, & Swaminathan, 2009). In Kenya, stock, bonds among others are traded at the Nairobi Securities Exchange which is regulated by the CMA.

The total equity market capitalisation of the listed companies as at 31 August 2002 was Kes 85.4 billion (US \$ 1.1 billion). In 1994, the NSE was at its peak and was rated by the International Finance Corporation (IFC) as the best performing market in the world with a rate of return of 179% in US Dollar terms. At that time, the NSE had a market capitalisation of Kes 137 billion which was equivalent to US \$ 3.1 billion at the then prevalent exchange rate of KShs 45 to 1 US\$ (CMA, 2012).

Statement of the Problem

In recent years, investors in Kenya have lost their investments through the Nairobi Securities exchange where stock brokerage firms are being suspended and listed companies experiencing financial problems (Cheserem, 2010). One such irregularity involved Nyaga Stockbrokers, a brokerage firm put on statutory management in 2008 after failing to meet its financial obligations (Ngigi, 2011). Consequently, over 25,000 investors lost vast amounts of money, lodging claims to the Capital Markets Authority for compensation through the Investor Compensation Funds (ICF). The CMA spent Shs302 million to paying investors a maximum of KShs50,000, since the State cannot afford to compensate the full amount invested, Nyagah stockbrokers top management (owners and directors) assets must be sold in order to compensate each and every investor of the firm (Ngigi, 2011). Based on a forensic audit done by PricewaterhouseCoopers (PwC), the firm might have gone down with about Shs1.3 billion of public funds and in addition to this diversion of funds by management, fraud by the staff, occurrences of collusion by other stockbrokers in the NSE, and even office of the regulator (Bonyop, 2009).

The collapse of stockbrokers has, over the years resulted in a confidence crisis at the NSE. Stockbrokers Francis Thuo and Discount Securities Limited went under, taking with them millions of investor funds and trust in the bourse (CMA, 2009). Discount Securities Limited risked NSSFs workers' pension fund losing billions invested. There was also the suspension of Bob Mathew's stockbrokerage licenses due to insufficient funds to meet clients' obligations (CMA, 2009). Some of the listed companies like CMC motors have been suspended due to boardroom wrangles and court proceedings on proper constitution of the board (CMA, 2012). The above events have resulted in the loss of billions of investors' money. This study, therefore, seeks therefore seeks to investigate the factors influencing the performance of Capital Markets in Kenya with reference to the Nairobi Securities Exchange.

Objectives of the Study

The general objective of this study was to investigate factors influencing the performance of capital markets. The specific objectives were as follows:

1. To determine the effects of corporate governance on the performance of the capital market.
2. To establish the influence of incentives to CEOs on the performance of capital market.

3. To examine how policies and regulations of CMA affects the performance of capital market.
4. To evaluate the effects of portfolio diversity on the performance of capital market.

Theoretical Review

Business Ethics Theory

Business Ethics theory focuses on the rights and wrongs in business. In understanding the ‘right and wrongs’ in business ethics theory, Crane and Matten (2007) injected morality that is concerned with the norms, values and beliefs fixed in the social process which defines right and wrong for an individual or social community.

The main role of corporate governance is to limit conflicts of interest between managers and shareholders, as well as the costs generated by such conflicts. Mizruchi (2004) asserts that managers must be controlled in order to avoid losses. Financial scandals, as seen at Enron, WorldCom, and Nortel in North America and Parmalat in Europe, and the astronomical costs associated with them, have reinforced this argument. As we have seen, such scandals can cause financial markets to drop sharply, jobs to be lost and pension plan values to plummet. For example, the largest American pension fund lost over one billion dollars through its investments in WorldCom (Reuters, 2002). The Caisse de depot et placement duQuebec, the largest pension fund in Canada, saw the value of its Nortel investments drop by five billion dollars between August 2000 and the end of December 2004 (Financial Post, 2004).

Agency Theory

Jensen (2004) states ‘the best way to increase the chances of making the best decisions possible is to ensure that the incentives (trade-offs) they face encourage them to move in the correct direction’. Over the past two decades, the academic literature on agency theory and executive compensation has argued that CEO compensation should be aligned to firm performance (Jensen & Murphy, 2004). Studies that address this link have focused on connections between pay and future accounting performance (Hayes & Schaefer, 2000). However, there are reasons to expect that information on CEO incentive pay may not be immediately impounded into returns. First, CEO compensation contracts may incorporate both observable and unobservable (to outsiders) measures of performance.

Secondly, incentive pay is potentially less than fully transparent, given the hard to value nature of the non-cash option component of pay. Bebchuk, Fried, & Walker (2002) argue that managers use incentive compensation to “camouflage” or facilitate the extraction of rents from shareholders. For example, the true value of option pay may be distorted by the apparent wide spread practices of option backdating and option repricing (Lie, 2005, Heron & Lie, 2007 and Narayanan & Seyhun, 2008). Additionally, pay practices, such as deferred compensation, may not be fully disclosed.

Stakeholder Theory

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1999) incorporating corporate accountability to a broad range of

stakeholders. Wheeler, Colbert, and Freeman, 2003 argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science.

Enforcement Theory of regulation

In contrast, Becker (1983) highlights the difficulties of implementing and enforcing regulation in a way that is socially beneficial. Against this backdrop, (Djankov, 2004) proposed the enforcement theory of regulation. Their premise is that all strategies for implementing socially desirable policies such as creating deep and functioning capital markets are likely imperfect and that optimal institutional design involves a tradeoff between imperfect alternatives. Shleifer (2005) applies this theory to securities regulation and argues that the “inequality of weapons” between corporate insiders and promoters on the one side and (often unsophisticated) outside investors on the other side makes it unlikely that private contracts with litigation are an efficient solution in securities markets. He suggests that, in this situation, regulation that prescribes what firms have to disclose to investors could be beneficial because it limits the discretion of courts and mitigates the “inequality of weapons” problem and in turn improves the performance of the capital markets.

Public Interest Theory of Regulation

Shleifer (2005) argues regulation of securities markets could be an instance in which regulation is beneficial to the economy. Consistent with this conjecture, almost all economies have extensive securities regulation. As mentioned earlier, there are several reasons to be skeptical about the benefits of regulation that would consequently result in improving the performance of the capital markets. Consistent with these concerns, much of the empirical evidence on the effects of securities regulation is mixed and often negative (Mulherin, 2007).

Transaction Cost Theory

According to Williamson (2008), this theory attempts to view the firm as an organization comprising people with different views and objectives. The underlying assumption of transaction theory is that firms have become so large they in effect substitute for the market in determining the allocation of resources. In other words, the organization and structure of a firm can determine price and production.

The combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms’ transactions to their interests (Williamson, 2008). The expanded universe of securities available internationally suggests the possibility of achieving a better risk-return trade-off than by investing in the domestic securities. This leads to higher returns for the same level of risk or less risk for the same level of expected return. Diversifying across nations whose economic cycles are not perfectly synchronous, investors should be able to reduce still further the variability of their returns.

Research Methodology

This study utilized a descriptive survey approach. The population of interest of this study comprised of the players in the capital markets who included the NSE member firms, CMA and

the listed firms. Random sampling design was used to select the sample that represented the population. The sample size consisted of 32 respondents drawn from stock brokers, CMA and the listed firms. There were six from the stock brokerage firms, eight from the CMA and four from each of the eighteen listed firms.

Sampling Frame

Population strata	Population	Sample %	Sample size
Stock brokers (member firms)	19	30	6
CMA	26	30	8
Listed Firms	60	30	18
Total	105	30	32

Results of the Findings

The researcher sought to establish the background information of the stock brokers and the firms. The findings on table 4.1 reveal that a greater proportion 3(50%) of the members are registered as investment banks, 2(33.3%) are registered as dealers while none had more than one license.

Corporate governance

The researcher sought to determine the effects of strict and formal corporate governance procedures on the performance of capital markets. It was found that the perception that the standards of good governance had a direct impact on the performance of a listed firm and thus on the performance of the capital markets. The respondents were however not sure whether strict and formal corporate governance procedures have contributed to the ability to find new and legitimate means of reducing financial risk.

The study sought to establish from the CMA representative the effective way of applying pressure on managers of listed companies in order to improve corporate governance, the findings revealed that the effective way is through the board of directors as indicated by 50% of the CMA representatives. The findings are in line with Claybrook (2008) who found that upper management also influences both operations and stakeholders. The CEO and the board of directors set the tone at the top and play an oversight role, which affects the corporate environment in terms of integrity, ethics, and other factors (Horton, 2009).

The study also sought to establish the priority set on corporate governance at the CMA. 4 (50%) of the CMA respondents indicated that it was top priority while the other 4 (50%) indicated that corporate governance was one of the top three priorities of the CMA.

The study sought to establish the person responsible for corporate governance issues in the listed firms, based on the findings 3(37.5%) have the board of directors responsible for corporate governance, another 3(37.5%) the CEOs responsible for corporate governance. As Djankov

(2004) argues that might be related to the pervasiveness of the insider control structure and not the successful functioning of the board of directors or audit committee

The research sought to establish from the listed firms the extent to which board members understand their responsibilities, from the findings 8(50%) of stock brokers indicated that the board members understand their responsibilities to a moderate extent while 5(33.3%) indicated that they understand their responsibilities to a great extent.

The findings also revealed that 10(62.5%) of the listed firms have between 1 to 5 members of the board while 4(25%) have between 6 to 7 board members. Only 2(12.5%) have above 10 board members. The findings imply with a few members of the board in most of the companies, the corporate governance in the companies might be compromised. Studies by Wen et al. (2009) and Abor (2007) both reported evidence in support of a positive relationship between board size and leverage. They argued that large boards with superior monitoring ability pursue higher leverage to raise the value of the firm.

The findings also revealed that 16(100%) of the listed firms that participated in the study have executive directors only as the composition of the board, this implies opinions of other directors are taken into consideration since there is no representation of other directors The findings are consonant with the findings of Chhaochharia and Grinstein (2007) and Beiner et al (2004), as they also find a positive relation between corporate performance and the composition of the board. Companies with independent board members tend to perform better as compared to others without independent board members.

Portfolio diversification

The study also sought to establish whether they stockbrokers had membership in capital markets outside Kenya. On proportion of revenues, the findings reveal that the majority (63.3%) of the stock brokers are not registered with capital markets outside Kenya and also the listed firms deal in a limited number of products and or services. This could then be the reason for the low performance of the capital markets in Kenya. Fauver, Houston, and Naranjo (2008) found that an internationally diversified portfolio is less than half as risky as a fully diversified domestic portfolio. Among the listed firms, only 16% deal in more than 10 products and or services.

Policies and regulations of CMA

The study sought to establish from the stock broker the effectiveness of the rules imposed by the CMA, from the finding 4(66.7%) of the respondents indicated that the rules are effective while 2(33.3%) indicated that the rules are very effective implying that the CMA is determined to improve corporate governance among the listed companies. The finding is in line with Chhaochharia and Grinstein (2007), who found that, in general, strict rules in the capital markets results to better enforcement corporate governance practices which in turn contributes to the good performance of the listed companies.

Incentives to CEOs

All the listed firms indicated they had a remuneration committee and a written remuneration policy. The finding revealed that 13(81%) disclose the remuneration policy in their annual report while the other 3(19%) do not. Findings revealed that 10(62.5%) of the listed firms have

between 4-6 directors as members of the remuneration committee while 4(25%) have 1-3 directors, this implies that the listed firms have put in place effective remuneration strategies to ensure good corporate governance. The findings are in line with Yermack (1996) which suggests that the smaller the remuneration committee the better the firm's performance. Yermack (1996) further argued that larger remuneration committees are found to be slow in decision making.

Coefficient Correlations

The correlation analysis shows that Policies and regulations of CMA and corporate governance were positively correlated as are incentives to CEOs and portfolio diversification. The findings indicate negative correlation between Policies and Regulations of CMA and the performance of capital markets. However, the findings indicate that portfolio diversification and corporate governance are positively correlated. The study also found that when the Policies and Regulations of CMA increase the corporate governance performance improves.

Discussions

Corporate Governance

On issues relating to corporate governance, the findings of the study reveal that when the Policies and Regulations of CMA increase the corporate governance performance improves. There is however a need for more research on the effect of strict and formal corporate governance procedures and how they contribute to the ability to find new and legitimate means of reducing financial risk the ability to take swift and effective decisions. The findings further imply that the success of a listed firm mostly depends on the efficiency of the board of directors. In corporate governance, employee representatives on the board of directors are important indicators for employees' needs to achieve optimum performance, commitment and effectiveness.

Incentives to CEOs

From the findings incentives to CEOs can be used to prevent the agency problem by aligning managers' interests with those of shareholders. Incentives to CEOs motivate managers to make sound business decisions that increase shareholder value so as to improve the performance of the firms which in turn contributes to improved performance in the capital market.

Policies and Regulations

The findings indicated that when the Policies and Regulations of CMA increase the corporate governance performance improves. The findings further indicated negative correlation between Policies and Regulations of CMA and the performance of capital markets. However, the findings revealed that portfolio diversification and corporate governance are positively correlated.

Portfolio diversification

The findings revealed that portfolio diversification results to expanded better risk-return trade-off for listed firms than by investing in the domestic securities. This leads to higher returns for the same level of risk or less risk for the same level of expected return. Portfolio diversification

significantly reduces the risk of portfolio return. Member firms of the capital market who are also member firms to capital markets in other countries bring in more diversification in the market.

Conclusions

Based on the findings of the study, it can be concluded that corporate governance in listed firms influences the performance of capital markets at high rate as most of the companies strive to achieve excellent corporate governance practices. Incentives to CEOs, the study concludes it influences corporate governance as the company's board regularly reviews systems, processes and procedures to ensure the effectiveness of CEO remuneration systems which in turn improves the performance of the listed firms and hence the performance of the capital markets. Policies and regulations, the study concludes that CMA regulations ensure that listed firms ensure good corporate governance which improves the performance of capital markets. Portfolio diversification on the other hand significantly reduces the risk of portfolio return and therefore much of the risk associated with individual markets can be eliminated by diversification.

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