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Review

# Role of board size on financial performance of commercial banks

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This paper constitutes a theoretical review of existing literature relevant to the subject. The emerging literature on corporate governance indicates that the size of a bank's board of directors has a direct relationship with its profitability. The size of boards of directors have been claimed to be an important influence on the performance of large firms. For many firms the role of boards' acts more as a substitute for the development of internal staff and management skills, indicating that for large firms' directors chiefly support the control role of Chief Executive Officer. In light of advancement, the purpose of this paper is to clarify role of board size on performance of commercial banks.

**Key words:** board size, Board structure and bank performance

## INTRODUCTION

The board of directors of a firm is the hub of its internal governance. Apart from providing strategic direction, board of directors provides a key monitoring function for dealing with agency problems in the firm (Fama, 1980; Jensen, 1993). In short, board of directors is constituted by shareholders to steer the affairs of their firm. Huang (2010) examined the effects of board structure and ownership on a bank's performance using a sample of 41 commercial banks in Taiwan. The results indicated that board size, is positively associated with bank performance. Board size is mostly used as an indication of both monitoring and advisory role (Klein, 1998). Empirical results on optimal board size are inconclusive. Large board size has been criticized for increasing cost and boardroom squabbles, while it is also argued that small board size might not effectively monitor powerful managers. The size of the board is also found to increase with firm age and firm size (Coles *et al.*, 2008).

### Overview of banking sector in Kenya

Kenyan Banking sector has continued to attract a lot of interest from international financial players. To this end, the number of licensed representative offices of top international banks has steadily grown from one (1) in 2008 to four (4) in 2011. Moreover a fifth institution was granted an approval in principle on 5th March 2012 to

establish a representative office in Kenya. This interest anchors well with Kenya's Vision 2030 that will make Kenya the premier regional financial services hub (RoI, 2008). For this reason, financial development and deepening will be strong outcomes. Financial infrastructure in Kenya can be considered complete. Banks; Microfinance Institutions; currency centres; credit reference bureaus; agency banking; risk-based supervision are indicators that the financial infrastructure in Kenya is now in place: with banks rolling out branch networks across the region supported by initiatives like agency banking and an appropriate information sharing mechanism allows the financial sector to grow. Then the other arms of Pension, Securities and Insurance are moving in the same direction. Kenyan banking sector has remained resilient despite the dynamic macro environment. This is evidenced by the impressive profit before tax of Ksh.89.3 billion (USD1.08 billion) for the year ended December 2011. This was a 20.4% increase from Ksh.74.3 billion (USD895 million) returned in the same period in 2010. The number of banks is growing to create strong banks (CBK. 2012).

There is a thrust of initiatives inculcated to ensure banking sector operates efficiently, effectively and soundly. The initiatives are anchored on three pillars namely: First, strengthening financial stability,

supervisory and regulatory framework. Second, enhancing Financial Integrity in the Banking Sector so as to ensure that the financial systems are safeguarded against money laundering and financing of terrorism. Third, promoting Financial Inclusion for financial deepening and development in line with the aspirations under the Kenyan Vision 2030 (RoK, 2008)

### **Board size and performance of commercial banks**

It is apparent that a board's capacity for monitoring increases as more directors are added. This has been the position of Klein (2002) and Andres and Vallelado (2008) who argue that a large board size should be preferred to a small size because of the possibility of specialization for more effective monitoring and advising functions. However, the benefit of specialization which [Klein \(2002\)](#) and [Andres and Vallelado \(2008\)](#) tout may be swallowed by the incremental cost of poorer communication and decision-making associated with larger groups. This view has been articulated by researchers such as Fama and Jensen (1983); Lipton and Lorsch (1992); and Yermack (1996) who favour small boards. Jensen (1993), for instance, has questioned the effectiveness of boards with more than about seven to eight members, arguing that such boards are not likely to be effective. He argues that large boards result in less effective coordination, communication and decision making, and are more likely to be controlled by the Chief Executive Officers of such firms. His hypothesis has since received empirical corroboration from findings by Yermack (1996) and Eisenberg et al., (1998). Eisenberg et al., (1998), in particular, find a significant negative correlation between board size and profitability in a sample of small and midsize Finnish firms. [Cheng \(2008\)](#) also lends credence to Jensen's hypothesis. His study provides empirical evidence that firms with larger boards have lower variability of corporate performance. Wu (2004) also finds that the presence of active institutional investors is associated with a tendency of firms to reduce board sizes, generally through the removal of inside directors.

Some theoretical approaches emphasizes the control role of directors, suggesting that as firm size increases the capacity of the directors to exercise detailed monitoring or evaluation of the CEO and senior managers decreases (Jensen and Meckling, 1976; Norburn and Birley, 1988; Daily and Dalton, 1992, 1993). The greater the degree of director control, the greater is the benefit to be derived from the directors' ability to limit the agent incentives that allow managers to pursue their own objectives rather than those that are in the best interests of the firm. Williamson (1985), Mizruchi (1988), Eisenhardt (1989), and others have emphasized that the importance of director control, acting in the shareholder or owner interests, tends to increase, the greater the extent of internal hierarchy and diversity, which is generally closely related to firm size. As firm size

increases and managerial structures take over from owner/proprietors, the potential for the control role of directors in support of the CEO will tend to increase. But in very large firms the ability to exercise that control will be limited by information asymmetry constraints and agency behaviour. This argument suggests, as in the expectations from the resource dependence theory, that there is a non-linear relation of the control role of directors with firm performance as firm size increases: little role for director control at very small sizes, an important role to support the CEO after the transition to managerial structures has occurred (often recognised to be at a size above about 30-100 employees (Atkinson and Meager 1994), with, perhaps, a diminishing potential to exercise control effectively as the firm becomes a large company.

Most arguments suggest that, beyond a certain size of business, or beyond a period of time when the founder's particular skills and leadership have been crucial, the widening of a management team can improve firm performance. Owner control does have the advantages of the "personal touch" (which may be particularly relevant in service industries); it allows direct communication of the vision of the firm to staff, customers and suppliers; and through a flat organization structure it emphasizes an ethical or trust relation between staff with a strong tendency to develop learning by doing (Willard *et al.*, 1992; Stanworth *et al.*, 1990).

There has been mixed response to existing relationship between board size and corporate performance. The direction of influence depends on the extent to which board is able to reach consensus, and take advantage of the knowledge and expertise of the individual members. Two contrasting views emerge from the extant literature on the contemplating effect of board size on firm value. One school of thought views larger boards as effective in driving the performance of company. Various researchers (Ehikioya, 2009; Coles *et al.*, 2008; Dwivedi and Jain, 2005; Klein, 2002; Dalton *et al.*, 1999; Kathuria and Dash, 1999; Pearce and Zahra, 1992) document a positive relationship of board size with the firm value. There have been several arguments in support of larger boards. One view is that larger boards allow directions to specialize, which in turn can lead to more effectiveness ([Klein, 2002](#)). Larger boards have people from diverse fields. The knowledge and intellect of this increased pool of experts can be utilized for making some strategic decisions of the board, which can drive performance of the company (Dalton *et al.*, 1999; Pearce and Zahra, 1992). The larger pool of people on the board results in greater monitoring capacity, and also enhances the firm's ability to form greater external linkages (Goodstein *et al.*, 1994). [Coles \*et al.\*, \(2008\)](#) find that firms requiring more advice derive greater value from the larger boards.

There are, however, strong contrasting views and evidences to the above argument. The contrary school of thought views, larger boards as less effective in

enhancing the performance of a company. Many researchers find a negative association between board size and performance of companies (Yermack, 1996; Eisenberg *et al.*, 1998; Cheng, 2008; Bonn *et al.*, 2004; Boone *et al.*, 2007; O'Connell and Cramer, 2010; Rashid *et al.*, 2010; Conyon and Peck, 1998; De Andres *et al.*, 2005, Ghosh, 2006; Kota and Tomar, 2010). Cheng (2008) suggest that larger boards exist even though they are value reducing, because they are necessary for some type of companies and under certain conditions. Coles *et al.*, (2008) point out that negative association of board size with firm value exists due to some other exogenous factors. Many scholars suggest that as board size increases above an ideal value, many problems surface which outweigh the benefits of having more directors on the board, as mentioned previously. In contrast to smaller boards, larger number of directors on the board increases the problem of communication and coordination (Jensen, 1993; Bonn *et al.*, 2004; Cheng, 2008) and higher agency cost (Lipton and Lorsch, 1992; Cheng, 2008; Jensen, 1993). Lipton and Lorsch (1992) suggest that dysfunctional behavioral norms and higher monitoring cost due to less diligence in larger boards give rise to severe agency problem. Larger boards may also have the problem of lower group cohesion (Evans and Dion, 1991) and greater levels of conflict (Goodstein *et al.*, 1994). Goodstein *et al.*, (1994) and Jensen (1993), argue that enhanced problem of coordination leads to slow decision making and information transferring, which drives inefficiency in companies with larger board size. Larger boards may be skeptical about taking a strategic decision that can maximize the value of the company (Bonn *et al.*, 2004; Judge and Zeithamal, 1992). The larger boards, therefore, may become more of symbolic nature, and less a part of realistic management process (Hermalin and Weisbach, 1991).

## CONCLUSION

The above discussion clearly lays down a platform to propose that board size may have positive or negative association with firm value. The vast literature on the impact of board size on firm performance, predominately foresees that board size is negatively associated with firm performance. Increasing number of directors on the board above an ideal limit may have more deteriorating effect on firm value. Below a certain board size, the relationship between firm value and board size is less negative and above that, it increases. Boards of larger companies have less negative association with firm performance than those of smaller firms. The argument is that boards of larger companies may well be equipped with resources, skill base and knowledge expertise to take strategic decisions in period of financial distress. The board of smaller companies may lag behind to actively utilize resources and drive performance.

Board of directors is considered to be an important governance device and boards are increasingly being

held accountable for the organizations they govern. High profile corporate collapses, leading to major economic losses, have raised serious doubt on the effectiveness of boards in protecting the interests of shareholders and other stakeholders. As a consequence, much of today's corporate governance reforms (codes and recommendations, regulation etc.) are directed at improving corporate governance through upgrading the board's functioning. Despite the fact that boards of directors are presumed to be vital for a company's survival, there is still relatively little known about the way boards actually operate. In most developing countries, boardrooms have been shielded from view, which makes them difficult to study.

Corporate governance and board research have mainly been influenced by agency theory, stewardship theory and resource dependency theory. From an agency perspective, the board of directors is an internal control mechanism designed to address the conflicts of interest between managers (agent) and shareholders (principal) and to bring their interests into congruence. Stimulated by the dominance of the agency theory in corporate governance, board effectiveness has commonly been viewed as the ability of boards to act independently from management to protect shareholders' interest. Structural board characteristics (e.g. size, insider/outsider representation, CEO duality) are treated in empirical studies as appropriate and adequate proxies for understanding board effectiveness. However, there is little definitive and striking evidence that these structural measures have had considerable impact on board or corporate performance.

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