Corporate Governance and its Role in Mitigating Risks in Stock Brokerage Firms in Nairobi, Kenya

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Abstract

The success or failure of any organization rests on its leadership. In the 21st century, corporate governance is becoming a matter of enormous public attention and concern. With regard to policy and regulatory changes that have taken place in the stock market in Kenya, more emphasis has been put on the need to improve corporate governance and strategic leadership practices of stock brokerage firms.The study adopted a descriptive design. A sample size of 64 managers from finance and operations departments was selected randomly in each organization involved in this study. The major findings were that all the brokerage firms have boards of directors. However, majority of board members did not have adequate skills, knowledge or experience in strategic leadership, stock brokerage finance and risk management.

The study concluded that corporate governance and strategic leadership practices were not being applied optimally to mitigate risks in the firms under study. This explained why several companies in the stock market had either collapsed or were experiencing financial distress.

Key words: Strategic leadership, Corporate Governance, Risk Management, Stock Market, Financial Distress

1.0 Introduction

Strategic leadership which requires that it be provided by the governance team, is the ability to anticipate, envision, maintain flexibility and empower others to create the needed organizational and long-term changes *(*Finkelstein, Hambrick & Cannella, 2008*).* In a company set-up, strategic leadership practice rests at the top, in particular, with the Chief Executive Officer, the board of directors and senior management officers *(*Kimutai, 2009).

On the other hand, corporate governance is the system by which organizations are directed and controlled. The governance team comprises of the board of directors, CEO and senior management *(*Muriithi, 2009*).* The task of corporate governance as observed by Cummings and Worley (2005) is to bring about necessary changes which are responsive to the long-term positive outcomes of all stakeholders.

In support, Frenkel, Hommel and Bufey (2005) observed that organizational controls which incorporate risks' mitigation are basic to a capitalistic system and an important part of strategic implementation and achieve their desired outcomes. However, Kaplan and Norton (2006) observed that some firms only use financial controls which produce more short-term outcomes and risk averse managerial decisions. As a result, outcomes are shared between the business- level executives making strategic proposals and the corporate-level executives evaluating them. In this connection corporate governance embraces strategic leadership, it can exploit the balance scorecard framework to ensure that they have established both strategic and financial controls to assess and boost performance, and reducing risk.

Sharma (2007) argued that intellectual capital, including the ability to manage knowledge and create and commercialize innovation, affect strategic leaders' success. The author observed that one of the most important tasks of the leadership in an organization is to unlock the natural state of creativity that sleeps within the minds of the followers. This will help the organization to experience the kind of innovation required to become a world-class corporation. On their part, Frenkel et al. (2005) argued that when a company is left with a void in leadership, the ripple effects are widely felt both within and outside the organization. .

1.1 Stock Market in Kenyan Context

In Kenya, shares dealings were initiated in the year 1920. The business was then confined to British settlers and investors since local investors were denied trading in securities (CBK, 1984). In 1954, the NSE was set up as a voluntary association of stockbrokers registered under the societies Act with permission of London Stock Exchange. Securities that were traded in the NSE during the period mainly comprised of government stocks, loan stocks, preference and common shares.

In November 1988 the Government set up the Capital Market Development Advisory Council and charged it with the role of working out the necessary modalities including the drafting of a bill to establish the Capital Markets Authority (CMA). In 1989, the bill was passed in Parliament and subsequently received Presidential assent. CMA was eventually constituted in January 1990 and inaugurated on 7th March 1990. The CMA was mandated to regulate and facilitate the development of an orderly, fair and efficient Capital Markets in Kenya. The main markets players in the Kenyan Capital Markets include; the Nairobi Stock Exchange, the Central Depository and Settlement Corporation Ltd, Stockbrokers, Investment Advisors, Fund Managers, Collective Investment and Authorized Securities Dealers (NSE, 2008).

Kilonzo (2009) observed that over the years, the Capital Market Authority has initiated a number of policies to facilitate the growth and development of the capital markets in Kenya. As a result, there has been an increase in the number of companies seeking to list at the Nairobi Stock Exchange. The authority is pursuing major reforms to strengthen its regulatory framework critical for the maintenance of investors' confidence as well as enhancing investors' protection.

The market infrastructure was also improved by installation of a computerized central depository system (CDS) introduced on November 2004 and whose operations included, keeping the share registry, clearing and settlement arrangement hence assuring faster, safer and easier trading insecurities *(*Kibuthu, 2005). According to NSE (2007), the Nairobi Stock Exchange saw the implementation of live trading on automated trading system on 11th September 2006. Trading is now done through the Electronic Trading System (ETS) which was commissioned in 2006.

In spite of this growth and development in this market, investors have been left disenfranchised after some stock brokerage firms collapsed resulting in huge loses for many investors. Several firms such as Nyaga Stock Brokers and Thuo Stock Brokers were declared bankrupt back in the year 2007. Discount Securities limited was also placed under receivership and several other companies were facing uncertainty because they were facing challenges in settling claims.. The big questions in both investors' and scholars' minds were whether these firms had a strong leadership and governance structure and if they practiced good governance and strategic leadership practices.

Walker (2005) observed that all organizations' management is vulnerable to a significant degree in their respective operations. However, the capability of its leadership makes a significant difference in how a firm operates and manages its risk. This study , therefore, endeavoured to establish whether Kenyan brokerage firms practiced strategic leadership and good governance.

2.0 Statement of the problem

The rate at which the stock brokerage firms have been collapsing in Kenya is alarming. Over the past few years, Kenyans have watched desperately as some stock brokerage companies collapsed, causing investors to lose huge investments to the tune of about Ksh3 billion *(*Daily Nation, Oct 28, 2009). This has led scholars and regulators to look into the issues of governance and leadership practices in stock brokerage firms. Walker (2005) argued that, though all organizations face significant risks in their operations, the capability of their leadership can shape the direction they take and a firm whose top leadership embraces good corporate governance practices is able to achieve above average results. Studies have been done on the role of leadership in organizational success. Others have focused on risk management practices in organizations. Little however, is known about the combined role of strategic leadership and good governance practices for organizational success, especially in the Kenyan context. It was therefore, important to conduct this research in order to establish whether strategic leadership and good corporate governance principles were being practiced in stock brokerage firms operating in the stock market in Kenya. Effective leadership is critical to organizational success and building strong organizations that investors can trust is contingent on the organization's corporate governance and strategic leadership practices.

2.1 Objectives of the study

1. To establish whether good corporate governance and strategic leadership practices were evident in the brokerage firms under study;
2. To determine the composition of the board of directors and their expertise in corporate governance and strategic leadership;
3. To establish whether governance and leadership practices in the brokerage firms helped to mitigate and control risks.

2.2 Overview of the role of strategic leadership in corporate governance

Finkelstein et al (2008) argued that, the success or failure of any organization rests on its leadership. firms collapse if the leadership suffers from the following weaknesses: The inability to respond or to identify threats, overestimating their ability to control firm's external environment, having no boundary between their interests and that of the company, a belief that they can answer all the questions, eliminating all those who disagree with them, and underestimating obstacles and relying on what worked in the past (Icarus paradox phenomenon). In addition, Sharma (2007) observed that organization collapse when the leadership fails to sell its vision to its followers, has not convinced its followers why they should be passionate and failure to make employees loyal to organizational agenda.

Sharma (2007) argued that to attain and sustain superior financial performance and win investors' confident, strategic leadership must guide the firm in ways that result in the formation of a strategic intent . Goffee and Jones (2006) observed that when the leadership dedicates itself to liberate rather than to stifle the talents of the people, it leads to quantum leap in loyalty, productivity, creativity and devotion to organization's compelling cause. As observed by Leavy and Mckieman (2009), strategic leadership facilitates in the development of appropriate strategic actions and supports their implementation.

Calder (2008) observed that in the 21st century, corporate governance has become critical for all medium and large organizations and is becoming a matter of enormous public attention and concern. Earlier contribution by Kaplan and Norton (2006) had observed that in today's competitive business environment, top leadership must be seen to practice good corporate governance practices. In particular, the authors observed that modern management tools such as, code of corporate governance, embracing regulatory laws and use of balance scorecard will go hand in and in ensuring high performance and mitigation of risks.

2.2.1 Risk Management

The term risk as noted by Francis (1993), originates from the Italian word, "riskare" which means to dare. The concept of risk in finance theory as noted by Fischer (1991*)* has undergone many changes in terms of its meaning. This author argued that it was also associated with the departure of the market value of the firm from its intrinsic value and uncertainty faced by the firm in earning adequate post-tax profits for paying reasonable dividends to shareholders. Francis (1993*)* argued that business leverage and liquidity risks assume a lot of importance as a major description of risk. Risk mitigation as noted by Radcliff (1990) is as old as trade and is the foundation of insurance industry. According to Frenkel et al (2005), risk management is an activity directed towards the assessing, mitigating and monitoring of risks. The investment process involves the leadership of the firm deciding on which investment to be undertaken and how much money to be committed to each investment. Allen (2003) noted that, a firm will seek to avoid risks in areas of ignorance or non-core activities while taking additional risks in others. The role of the governance team is to assess sources of risk which include liquidity risk, interest rate risk, foreign exchange risk, operation risk among others. It is the responsibility of the leadership to put in place some policies that will govern how much risk is acceptable without compromising the company's survival.

Risk identification requires an overall understanding of the business and the specific economic, legal and regulatory factors that affect the business (Harrington, 2004).The principle goal of risk management in a firm is to eliminate or minimize the possibility of adverse outcomes *(*El-Masry, 2006 Francis (1993) notes that a firm may apply various approaches to mitigate risks which may include insurance and hedging; Organization can undertake two different kinds of hedging: operational and financial hedging.

2.2.2 Theoretical framework

There are a number of theories used to explain and analyze corporate governance. Some of these theories as noted by Pandey (2006*)* are the agency theory which arises from the field of finance and economics, the transaction cost theory arising from economics and organizational and the stakeholder's theory. Other approaches include the organizational theory and the stewardship theory. While there are marked differences among these theories, this study critically examined the commonly used theory in details- the agency theory which is mainly used in accounting and finance related disciplines.

3.0 Materials and Methods

To investigate the extent to which strategic leadership and good governance practices were used to mitigate risk by brokerage firms, descriptive research design was the most appropriate. The study integrated both qualitative and quantitative methods. Quantitative research produced discrete numerical or quantifiable data. On the other hand qualitative research method dealt with non-numerical data and emphasized words rather than quantification. The method used also incorporated a census since the number of brokerage firms was small. The population of the brokerage firms and Investment banks was 18 by the time of study (NSE, 2009). The number of respondents in those firms was 18.

4.0 Results and Discussions

4.1 Good corporate governance practices

The research wanted to find out whether the organizations had boards of directors. All the respondents 100% indicated that the organizations had boards of directors which provide leadership in financial performance and strategic mission. However, over 50% of the boards did not have directors who are skilled in risk management. Some boards did not fully comply with principles of good corporate governance. These findings may explain why some firms had either collapsed or were in financial distress.

4.2 Mitigating and controlling risk

In relation to risk mitigation and controls, the researcher wanted to establish whether the brokerage firms had risk department. On the presence of risk management department in the organization, 67% respondents indicated that a risk management department did not exist and 33% said that it existed. The majority of the respondents indicated that the risk management department did not exist. This may help to explain the reasons behind the collapse of some brokerage firms. As noted by Frenkel et al (2005) risk management strategies are essential for helping firms to achieve their desired outcomes.

The research further wanted to establish the types of risks the firms being studied focused on mostly in their mitigation strategies. The risks the firms focused on were interest rate risks as indicated by 40% of the respondents, 33% of the respondents indicated operational risks while 27% of the respondents indicated that the focus was on market risk. The findings indicated that majority of the firms focused on the interest rate risks

perhaps because this type of risk has more than one cause in terms of price risk, reinvestment risk, prepayment risk and extension risk (Allen, 2003).
The research also wanted to establish the various approaches the firms were using to mitigate risks. The responses above revealed that the most common approaches to managing risks were Board involvement, insuring risks and use of a risk management committee. Operational and financial hedging were not key strategies in the firms studied. This could explain why many of those firms under study were weak in mitigating risks.

All the respondents agreed that good corporate governance practices are essential for organizational success. The research ,however, observed that not all firms had put in place mechanisms for good corporate governance and strategic leadership practices.This may explain the collapse of brokerage firms in Kenya.

The research also showed that all the brokerage firms had boards of directors but majority of board membersdid not have adequate skills, knowledge or experience in strategic leadership, stock brokerage finance and risk management.This meant that some firms under study did not practice good principles of corporate governance. This was a departure from Goffee and Jones (2006) who argue that strategic leadership and good governance lie in mastering a wide range of skills which are essential for corporate success. Leavy and MacKieman(2009) further argue that strategic leadership practice facilitates the development of appropriate strategic actions for corporate success.
The study also found out that independent non executives' directors were not actively involved in providing strategic direction in the firms studied though they are key in providing technical expertise and independent thinking according to corporate governance experts(OECD,2004) . This phenomenon could somehow explain the cause of corporate failure of some brokerage firms.Francis(1993) argues on the need for an organization to establish a mechanism for managing risk. One such mechanism entails the presence of independent directors in corporate boards.
The fact that 67% of the firms studied did not have a risk management department could also help explain why some brokerage firms collapsed. This agrees with Madura(2006) on the importance of a structure that assists an organization in mitigating risks.
This study brought to light the fact that firms need to put much emphasis on strategies that would help them mitigate risks. In addition, independent thinking at the board level is a critical ingredient in establishing boards that practice good corporate governance

5.0 Conclusion and Recommendation

This study established that strategic leadership and governance practices in the firms under study were weak and that those firms did not have specialised units to deal with risks. These findings explain why some stock brokerage firms either collapsed or were facing financial distress.The research therefore recommends that brokerage firms strengthen their governance structure and risk mitigation mechanisms.

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