The Failure of Corporate Governance in Chase Bank

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Introduction

The complexity of the business world coupled with the need to appeal to the global markets forms the basis for the separation of ownership and control. The business world has become more complex, with regulators requiring compliance. The talents needed to run the business efficiently may not reside with the owners of the business.[114] Therefore, the shareholders who are the providers of risk capital have to hire competent managers to run the business on their behalf. These managers exercise delegated authority for the benefit of the principals (owners of the company). The main goal is usually to maximize the shareholder wealth, a goal that is heavily disputed by the stakeholder theorist who believes that the goal should be broadened to include other stakeholders such as the employees, government creditors, and the environment.[115]

Similarly, the resource-based theorist vouches for the separation of powers. These commentators believe that organizations with the best managerial talents are best suited to outperform their peers who do not have the talents. This belief is founded on the fact that it is near impossible to imitate the managerial expertise of an individual. These managers are also capable of forecasting the future and driving the

114. McColgan, Patrick. "Agency Theory and Corporate Governance: a Review of the Literature from a UK Perspective" Working Paper Series. University of Strathclyde, May 22, 2001. http://accfinweb.account.strath.ac.uk/wps/journal.pdf.

115. Fama, Eugene F. "Agency Problems and the Theory of the Firm." The Journal of Political Economy 88, no. 2 (April 1980): 288-307.

business in dimensions that the owners would not have done if they were left to run the business on their own. This, therefore, necessitates the need to hire competent managers to run the business on behalf of the shareholders. However, this is not devoid of risk as the managers may decide to maximize their wealth instead of maximizing the wealth of the owners. The owners, therefore, have to institute measures geared towards ensuring that the managers engage in activities that maximize their wealth, which measures are broadly defined as corporate governance.

The agency theory which was proposed by the seminal works of Jansen and Meckling offers a theoretical explanation of the relationship which subsists between the managers and the shareholders. The theory avers that the agents or people who are exercising delegated authority are more prone to serve their interests as opposed to serving the interest of the master.[116] Indeed, the separation between ownership and control of the company forms the basis of the agency's problems. Human beings are engineered to take care of themselves first before they take care of other people's wealth. The other problem with the principal agency relationship is caused by natural indolence where the agents decide to give just slightly below average. Human beings are assumed to be naturally lazy and will choose to give less over giving more. The other problem with agency relationships is incompetence. This problem is related to adverse selection caused by the inability of the principal to select the most qualified managers or by a willful decision by the managers to select a choice of action that will lead to suboptimal results. Nonetheless, managers are capable of hiding their incompetence during the selection process.

One of the ways to deal with the conflict of interest is to institute strong corporate governance mechanisms. Corporate governance is the set of controls that are designed to protect the interest of capital owners. These

116. Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure." Journal Of Financial Economics 3, no. 4 (1976): 305-360.

capital owners include shareholders, creditors, and lenders. However, the shareholders take a keen interest in the development of the governance structure since legally they control the operational and strategic direction of the company.[117] In most cases, the shareholders also have a larger share of risk in the company. One of the challenges with the assumption that shareholders will more often than not design the corporate governance mechanism is that the shareholders may lack the technical know-how to design appropriate control for the company. Additionally, they may also lack the ability to monitor the actions of internal management effectively.[118]

One way to remedy this is through the use of alternate directors who represent the shareholders. These alternate directors usually have the expertise in how corporations run and are more likely to monitor the actions of management.[119] Additionally, the shareholders can cede some ownership to the institutional investors. These investors usually have in-depth knowledge of how to run the organizations and are likely to assist the shareholders to manage the aggressive behavior of management which may erode the value of the company.[120]

Historical Development of Chase Bank

Chase Bank was founded in 1996 with a primary focus on small and medium-sized enterprises. Even though the bank had a noble intention to fight the problem of financial exclusion for marginalized enterprises its foundations were shaky.[121] The bank was purchased from the United

117. Roberts, John. "Trust and control in Anglo-American systems of corporate governance: The individualizing and socializing effects of processes of accountability." Human Relations 54, no. 12 (2001): 1547-1572.

118. Ringe, W.G. "Independent directors: after the crisis", European Business Organization Law Review, Vol. 14 No. 3(2013), pp. 401-424.

119. Agnes Cheng, C. & Reitenga, A. Characteristics of institutional investors and discretionary accruals. International Journal of Accounting and Information Management, 17(2009) (1), 5-26.

120. Chung, Kee & Zhang, Hao. Corporate Governance and Institutional Ownership. Journal of Financial and Quantitative Analysis. (2009) 46. 247-273. 10.1017/S0022109010000682.

121. TWF (2014). "Chase Bank History". Theworldfolio.com (TWF). Retrieved 19 July 2022.

Bank of Kenya which was under receivership due to mismanagement of funds. At the time of its purchase, the bank was worth only 1.9 million USD, nevertheless, the value of the bank grew to 1.42 billion by the time of its liquidation.[122]

In April 2016, the bank was placed under statutory receivership through an intervention of the Central Bank of Kenya. The reasons behind this included liquidity challenges and non-performing loans, the majority of which were insider loans. The books of accounts also showed that profits had reduced from 2.3 billion in 2014 to 742 million in 2015. Consequently, the veil of incorporation was lifted and the directors of the bank were arrested and charged in their personal capacity. The financial probity of this magnitude was caused by willful negligence on the part of the directors and they had to take personal responsibility for their actions.[123]

Corporate Governance Challenges at Chase Bank

Byoffering intermediation services to the economy, commercial banks mobilize funds from those with net savings and lend the funds to net borrowers in the economy. The essence of intermediation is to win the trust of depositors and mobilize savings which can then be used to provide loans at a higher rate than the amounts promised to the depositors. More often than not the assets owned by the bank are usually contributed by the depositors rather than the shareholders. This is unlike other businesses which rely on either their shareholder's capital or lenders' funds to do business. As a result of this unique business environment, the corporate governance of commercial banks is more complex than other organizations. In most cases, you will find an inverted risk structure

122. CBK (19 April 2016). "Directory of Licensed Commercial Banks, Mortgage Finance Institutions and Authorized Non-Operating Bank Holding Companies: Commercial Banks" (PDF). Central Bank of Kenya (CBK). Retrieved 19 July 2022.

123. Chase Bank to re-open next week Wednesday under KCB management". Citizentv.co.ke. Retrieved 23 July 2022.

since the shareholder's contribution is a small fraction of the total assets of the bank usually between 5% to 20%. Yet in the non-banking sector, 70-80% of the assets are funded by the shareholders.

In principle, therefore, the owners of the bank are the depositors since they provide a larger proportion of funds that form part of the bank assets. This creates a unique principal-agent relationship between the depositors and the shareholders since the depositors provide funds that are lent to the borrowers. However, the law does not recognize the depositors as the principals. This, therefore, creates a governance loophole where the shareholders can exploit depositors for their gain. A major contribution to this loophole relates to the fact that the depositors individually contribute an insignificant amount of money which cannot enable them to negotiate for control. However, their collective efforts are significant and deserve to be protected through government intervention.

The law envisions this problem and has created a regulator to protect the interest of the vulnerable depositors. Corporate governance in the banking sector is usually administered through the prudential guidelines issued by the Central Bank of Kenya. These guidelines specify how the bank should be managed and how the managers should take the risk. The regulator also monitors the actions of the senior managers to determine if the bank is managed by the prudential guidelines. The regulator also approves the hiring of senior managers to ensure the banks have qualified personnel in the right positions. These interventions are taken because of the fragmentation of the depositors whose investments are at risk. Without prudential guidelines, the shareholders and managers may take unnecessary risks which may jeopardize the investments of the depositors.

Even though the central bank has enacted regulations that govern how banks should accept risk, managers and the shareholders sometimes still take the uncalculated risk. They can do this by structuring complex products which cannot be easily discovered, they can also award loans to

borrowers who cannot repay nor have the will to repay. Sometimes the said borrowers are parties related to the directors and senior staff. The Central Bank may have the willpower to monitor and prevent the occurrences of these malpractices. However, the complexity of the banking systems requires more than willpower as one needs to have intelligent monitoring systems to assist in digital monitoring. The traditional audits which are conducted regularly by CBK rely on ineffective sampling. Moreover, the insiders (managers) usually have more information than the regulator.

In the case of Chase Bank, there was a unique governance structure since it was owner-managed. The founding director, Zafrulla Khan, was also the CEO at some point but resigned to become the chairman of the board. He led the bank with a tight fist given that he was the chairman and also the largest shareholder of the bank. Ordinarily, one would expect that owner-managed firms have stronger internal controls as compared to other forms of governance structure. This is because in owner-managed institutions the owners are involved both at the strategic level and the operational levels. This gives them a rare opportunity to monitor the aggressive behavior of management. However, the case of Chase Bank was a bit different since the shareholders' value was far much less than the deposits. Just before its collapse in 2015, the bank had an estimated asset value of 142 billion and a shareholding of 11.9 billion. This means that the bank owners only contributed 8 % of the total assets, the remaining 92% was contributed by the depositors.

It is clear from the foregoing that the depositors were more at risk than the shareholders, yet they had little control of the enterprise. The shareholders, therefore, owe them a duty of care while managing the company. However, they relied on prudential guidelines and external audits to protect their interests.

What led to the collapse of Chase Bank?

The forensic audit conducted by Deloitte revealed that Chase Bank fell as a result of malpractices conducted by the owners and managers.[124] The owner and chairman of the bank utilized his position and influence to award his company's tenders worth 15 billion. The forensic auditors found that these contracts were used to siphon the bank's money without a corresponding service offered to the company. The scheme was designed to earn some money on the topline, a strategy used to incur fictitious business expenses to reduce profit. This strategy was used by the bank chairman because he wanted to earn more dividends than other shareholders at the expense of the bank.

The chairman also used a special purpose vehicle to transfer the physical and financial assets of the bank through Musharaka agreements. These agreements were ostensibly designed as partnerships with the bank.[125] These transactions led to serious losses which negatively affected the profitability of the bank. The special purpose vehicles also transferred some of the bank assets to Musharaka parties. The forensic audit revealed that the parties were related to the chairman of the bank and some senior managers. These agreements were also not approved by the board meaning that it was a sole decision by the chairman.

The other problem which was identified by the audit is that the bank had lent more than 118% of its core capital to the internal management, directors, and staff. This was against the prudential guidelines which limit internal lending to 25% of the core capital.[126] The insider loans were reported at 13 billion as compared to the 11 billion core capital. Most of these loans (60%) were borrowed by directors and senior managers and they were non-performing. Additionally, the bank awarded irregular

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124. Wairange,L.W., Link between Corporate Governance Failure and Collapse of Major Banks in Kenya. Unpublished MBA thesis (2018).
125. Dennis.An Illicit Affair; the Case of Chase Bank Kenya Limited. Burnley. 2022.
126. CBK Prudential Guidelines on Lending; central bank.go.ke

loans to the related parties that were not supported by any security. These were companies that were partly owned by the directors. The prudential guideline requires that this information be disclosed as insider loans. However, information about related parties was not disclosed. For instance, loans worth 1.1 billion were issued to Camelia Investment, Coilbrook holding, Cleopatra holding, and golden Azure investment. These companies were fully owned by the chairman and as such, they should have been disclosed as an insider loans.[127]

Ordinarily, the owners of the corporation are supposed to watch over the affairs of the company with more vigilance than the managers. However, in the case of Chase Bank, the chairman/owner who was actively involved in the management utilized his vantage position as an insider to defraud other shareholders and depositors. This is one of the main challenges of a family-run business where owners can make decisions without consulting management. The financial audits should have unearthed these malpractices, but they are periodic. However, audits rely on sampling and sometimes the sample does not pick the affected transactions. Both the CBK and external audit did not flag the suspicious transactions because they were well crafted.

Ordinarily, the financial auditors are supposed to help the Central Bank of Kenya to monitor the actions of management. However, the company act mandates the shareholders to select the auditors. This means that the auditors work for the shareholders and not the depositors. This, therefore, means that rogue shareholders can manipulate the auditors for their selfish gain. There seems to be a problem that was not envisioned by the Company Act 2015. An audit is designed to assure the shareholders that the books have been prepared by the international financial reporting standards and also to ensure that the financial statements are a faithful representation of what transpired.

127. Delloite Forensic Audit 2017.

Which systems failed and how can the failure be corrected?

The Central Bank of Kenya which is mandated to regulate the operations of commercial banks in Kenya failed to detect the malpractices. This is because the regulator depends on the periodic audits and monthly reports issued by the banks. The weaknesses were a result of a lack of proper systems to flag suspicious transactions. The Central Bank does not have a mechanism for identifying that the bank has originated a loan to a related party. They rely on the disclosure by the banks and periodic audits. The periodic audits have a major weakness because they depend on sampling. The Central Bank should invest in machine learning (ML) and artificial intelligence (AI) systems that can flag insider loans. They should also collaborate with the Registrar of Companies to provide them with real-time data on cross directorship, particularly for directors and senior managers in the bank. This will help them identify on a real-time basis when a loan has originated from a related party.

The financial reporting system by the time of the bank failure used the incurred loss model to recognize non-performing loans. This is unlike the current financial reporting system which anticipates loses and reports them at the point of loan origination. The incurred loss model was also blamed for the failure of the global financial system in 2007/2008. The chairman of Chase Bank knew that the rule-based system would favor his fictitious deals and, therefore, proceeded to award loans to his friends and family who did not even qualify for them. The expected loss model of recognizing non-performing loans would have helped to detect fraudulent transactions. This is because this financial reporting system relies on an independent evaluation of every customer's risk at the origination of the loan rather than waiting for the customer to default in order to report.

Before the failure of Chase Bank, the external auditors had issued a good report for the bank, their initial statement read in part:

> *We have audited the financial statements annexed to this document, and based on the available evidence we are satisfied that the business will be a going concern and that the financial statements represent a faithful representation of what transpired in the company.*

The auditors later issued a qualified opinion (bad opinion) based on the discovery that there were some fictitious transactions. These events revealed the weaknesses in the audit system, particularly in an emerging economy such as Kenya. This economy does not have so many corporations which can pay high audit fees. The auditor's independence can therefore be impaired since they rely on too few business deals and, as such, they would like to maintain the relationship by issuing good reports.

The other problem relates to the manual periodic audits which are conducted on millions of transactions. These methodologies have been replaced with continuous audits using advanced technology which can help the auditors detect suspicious transactions. Well-designed ML and AI algorithms may help the auditors detect insider lending, suspicious transactions, money laundering, and fraudulent transactions better than the manual systems. However, the initial cost of these systems is too high and this calls for government intervention. The government can also help in the process by creating an integrated database detailing the shareholding of directors and their related entities. In developing countries, cross directorship services have helped the auditors to detect and report related party transactions. This service is currently unavailable in Kenya.

Recommendations

The evidence from the Chase Bank case exposes the failures of periodic audits, which audits rely on statistical inference thus increasing the chances of error.[128] Given that the banking sector has complex systems and products, its monitoring and control needs to utilize the use of technology. The traditional audits are outdated and the assumption that it is the director's responsibility to prepare books of accounts that represent faithfully what transpired in the company is inadequate. This is because the highest risk takers are depositors yet they have no operational and strategic control. The Central Bank of Kenya must, therefore, use machine learning and artificial intelligence to detect anomalous transactions and flag them before they are approved. The machine learning software can be trained to detect all suspicious transactions.

The Central Bank needs to nominate an alternate director, who sits on the boards of banks, with veto powers on some decisions. This alternate director is likely to protect the interest of the depositors by ensuring that the strategic decisions made by the banks are considerate of the depositors' funds. This proposal will also provide more inside information to the regulator. Moreover, the concept of alternate directorship imports competence in monitoring. As such, the Central Bank should hire competent directors who can monitor the actions of senior managers. This will not only help the bank to monitor the affairs of the bank, but also assist the shareholders to discover the weaknesses in the internal controls which they would not otherwise known without the competent eyes of an alternate director.

128. Ravenstein, Judith & Georgakopoulos, Georgios & Kalantonis, Petros & Kaldis, Panagiotis.. Does Audit Quality Influence the Relation between Earnings Management and Internal Control Weakness in the Post –SOX Period. International Journal of Sustainable Economies Management. (2015).2. 70-100. 10.4018/ijsem.2013040105.

Conclusion

The collapse of Chase Bank is a reminder that the shareholders' wealth maximization goal can lead to sub-optimal results.[129] In the case of Chase Bank, the shareholders of the firm maximized their wealth albeit through dubious means. The stakeholder approach is better since it incorporates all the stakeholders involved. The justification for the stakeholder's approach is premised on the fact that the organization derives its basis of survival from the environment it operates. The resources which support its existence are mainly derived from nature, the customers who buy its products and services exist within the ecosystem, the regulators are also interested in protecting both the environment and the investments, and the employees who work for the organization deserve to know if their future economic welfare is assured.

Shareholders must also take up their role of setting up the tone of the governance structure, these are usually general principles guiding the management on how the organization should be run.[130] The board of directors cannot be trusted to deliver on its mandate without monitoring. The shareholders should, therefore, incur additional agency costs by employing an external auditor to assure that the company resources have been used for the goals and aspirations of the shareholders. This does not guarantee that the company will be successful because a company set on the wrong premise will still fail even if the resources have been used for the intended purposes.

Ultimately, there is need for a cultural shift in the management of corporations because the solution does not lie in policies, but enforcement and promotion of accountability. The overly capitalistic mindset promotes self-centeredness and consequently leads to the mismanagement of

129. U.S. Senator Elizabeth Warren. "Companies Shouldn't Be Accountable Only to Shareholders." The Wall Street Journal. August 15, 2018.https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687.

130. Robert J. Rhee. "A Legal Theory of Shareholder Primacy." University of Florida Levin College of Law. 2017. https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1004&context=working.

resources. A broken moral fabric does not only affect the board, but also the employees who are supposed to operationalize the strategies of the company. Therefore, as a nation, we need to fix our belief system to ensure that corporations are well managed for the benefit of society.