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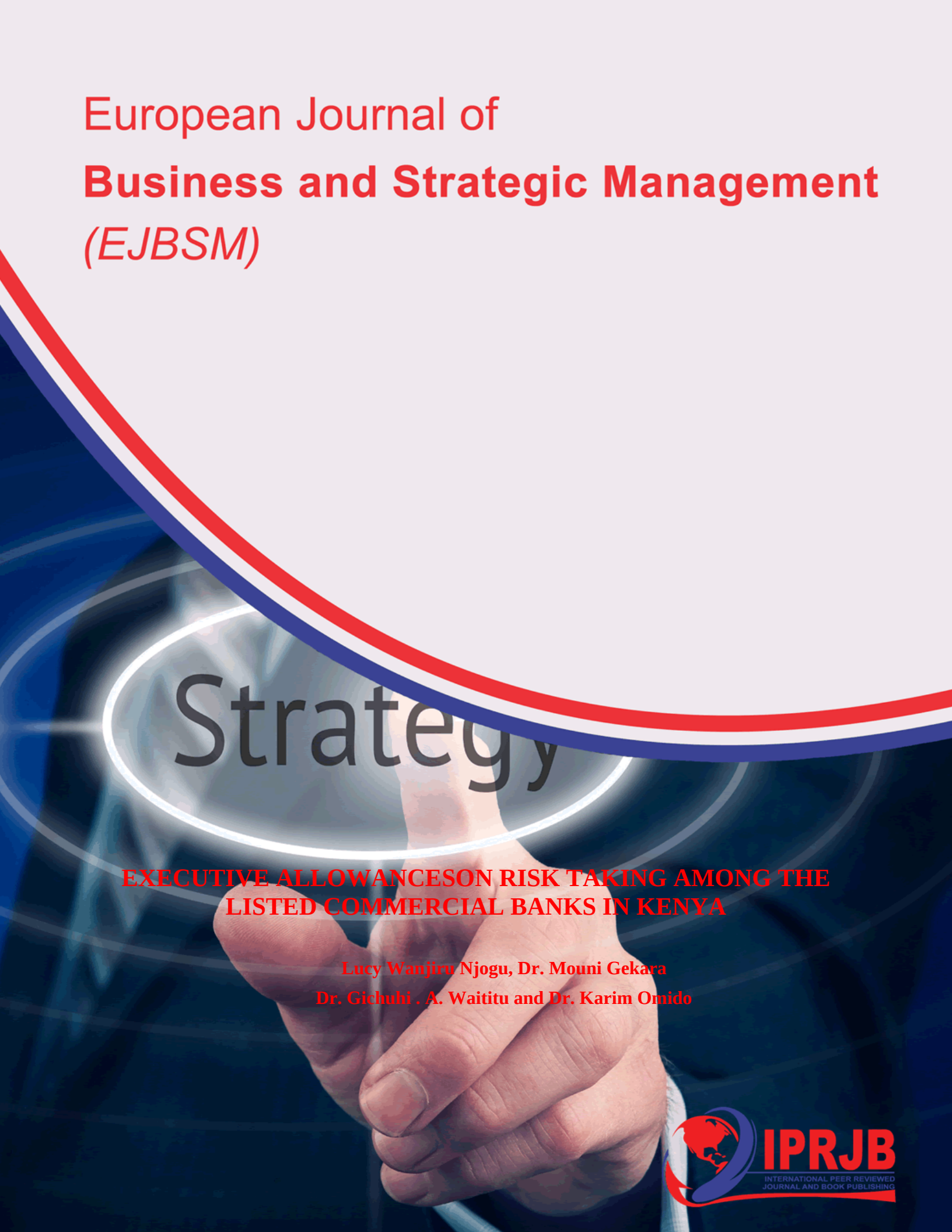

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EXECUTIVE ALLOWANCES ON RISK TAKING AMONG THE LISTED COMMERCIAL BANKS IN KENYA

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Abstract

Purpose: The purpose of this study was to determine the effect of executive allowanceson risk taking among the listed commercial banks in Kenya.

Methodology: The study used an Epistemology research philosophy, causal research design was adopted whereby panel data approach was used. The target population for this study were the 11 listed banks on the NSE. Secondary Data for the year 2010 to 2015 was collected from the NSE handbook. Data collected was analyzed using descriptive statistics which included means and standard deviations. Inferential statistics such as Pearson correlation and panel regression was also used. The results were presented in form of tables, figures, charts, graphs and trend lines.

Results: The study findings revealed that Executive Allowances and risk taking were negatively and significantly related.

Policy recommendation: The study recommended that banks should entice their staff with huge allowances as this will decrease risk.

Keywords: *executive allowances, risk taking*

1.1 INTRODUCTION

Executive compensation is presently one of the most interesting and innovative fields of research in the finance area. It was only in the 1990s, with the growth of the world economy, that shareholders felt the need to contract executives and give them incentives to make firms' stock market growth increasingly faster each year. Academics and researchers started searching for the best form of compensation to motivate these executives. It was not only the values that mattered, but also the way in which executives were paid: with more short term compensation (salary or bonus) or more long term compensation (stock options, restricted stocks, long-term incentives plans) or even with other forms of compensation like perks, and the impact of these compensation policies on all the fields of finance (Paolo, 2008).

Risk is a natural element of business and community life. It is a condition that raises the chance of losses/gains and the uncertain potential events which could manipulate the success of financial institutions (Crowe *et al*, 2009). Excessive risk-taking is viewed as a contributing factor to the market turmoil that erupted in the United States around mid-2007. Among the most frequently debated channels that have propagated the accumulation of risky exposures are ill-designed compensation policies, capital regulation, originate-to-distribute business model, low short-term interest rates, and others.

1.2 Statement of the Problem

A major criticism of executive pay packages has been that they incentivize excessive risk-taking which contribute to the financial turmoil. To respond to these concerns, governments and regulators have taken steps to restrict executive pay arrangements in regulated industries. However, there is still ongoing debate in the financial literature and among policymakers regarding how has executive pay contributed to bringing about the 2008 financial crisis, how to fix compensation structure and if pay structures should be reformed, what role if any should the government play in bringing about such reforms (Alon&Yoram,(2010).

Many studies when attempting to find causal relationships between CEO pay and risk taking find mixed evidence (Spitz-Oener, 2006). Mueller and Spitz-Oener (2006) examine 356 German financial service firms and find a link between pay and company risks in that a higher percentage of managerial ownership shares correlate positively with increases in firm risks. Lam and Chng (2006) find that managerial stock options correlate positively with firm risks. There are other studies (Sloan, 1993; Carpenter & Sanders, 2002; and Kerr &Bettis, 1987) that find a strong relationship between risk measures and executive compensation. Chesney *et al* (2012) find a strong negative relationship between the abnormal CEO compensation and excessive risk taking for the group of banks that do not report their Tier 1 ratio (predominantly, investment banks) Palia and Porter (2004) examine data for U.S. holding companies and find that the increases in salary and bonus components of managerial compensation were associated with lower risk. Duru (2005) demonstrate that the earning-based cash bonuses help to reduce risk-taking incentives of managers, whereas Hagendorff, *et al* (2015) find an empirical support to this idea, showing that higher bonuses entail a lower default risk.

Most studies in Kenya have concentrated on Executive Compensation and Ownership structure and Bank performance and not on the risk taking component. Such studies include Aduda (2011)

who did a study on the relationship between executive compensation and firm performance in the Kenyan banking sector. Asala (2012) did a study on the determinants of executive compensation in Kenya for firms listed on the Nairobi Securities Exchange. Mululu (2005) did a study on the relationship between board activity and firm performance of firms quoted on the Nairobi Stock Exchange.

This study intends to delve into how executive compensation influences the systematic risk among listed commercial banks in Kenya by evaluating how various compensation types; such as share ownership, fixed salary, allowances and annual bonuses affects the riskiness in the banks stocks.

1.3 Objectives of the study

In addressing the general objective, this study pursued the following specific objectives;

i. To determine the effect of other executive allowances on risk taking among the listed commercial banks in Kenya

2.0 LITERATURE REVIEW

2.1 Theoretical review

2.2.1 Principal Agent Theory

The principal-agent problem was first written about in the 1970s by theorists from the fields of economics and institutional theory. Michael Jensen of Harvard's Business School and William Meckling of the University of Rochester published a paper in 1976 outlining a theory of ownership structure that would be designed in such a way as to avoid what they defined as agency cost and its relationship to the issue of separation and control. These issues are central to the principal-agent problem. The separation of control occurs when a principal hires an agent, and the costs that the principal incurs while dealing with an agent can be defines as agency costs. These agency costs can come from setting up monetary or moral incentives set up to encourage the agent to act in a particular way.

A more widespread acceptance of the concept of agency costs and principal agent theory, formalized by Jensen and Meckling (1976) can be seen as the starting point for the modern executive compensation research. In short the agency theory identifies the separation between ownership (shareholders) and control (management) as the main reason to why executive compensation systems need to be designed such that they achieve an alignment of interests between the owners and the management of the firm. Related to this the following is argued; “The principal can limit divergences from his interest by establishing appropriate incentives for the agent” (Jensen and Meckling, 1976. p. 308). The principal agent theory has a strong focus on so-called agency costs, which can be seen as the driving factor for how the executive compensation system should be structured from a theoretical point of view. According to this theory the executive compensation system should be structured such that the agency costs that the shareholders have to bear, originating from differences in interests between the agents, are minimized.

2.2 Conceptual framework

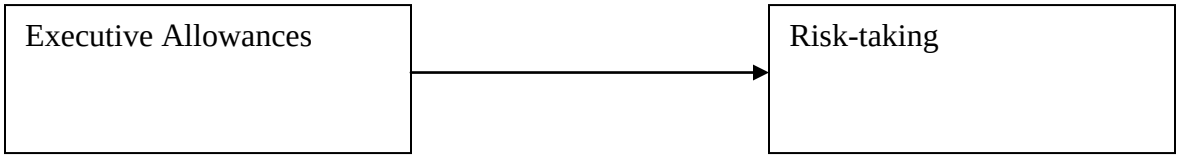

Figure One: Conceptual framework

3.0 METHODOLOGY

The study used an Epistemology research philosophy, causal research design was adopted whereby panel data approach was used. The target population for this study were the 11 listed banks on the NSE. Secondary Data for the year 2010 to 2015 was collected from the NSE handbook. Data collected was analyzed using descriptive statistics which included means and standard deviations. Inferential statistics such as Pearson correlation and panel regression was also used. The results were presented in form of tables, figures, charts, graphs and trend lines.

4.0 RESULTS FINDINGS

4.1 Diagnostic tests

4.1.1 Multicollinearity Test

According to Field (2009) VIF values in excess of 10 is an indication of the presence of Multicollinearity. The results in Table 4.2 present variance inflation factors results and were established to be 1.26 which is less than 10 and thus according to Field (2009) indicates that there is no Multicollinearity.

Table 1: Multicollinearity Test

Variable	VIF	1/VIF
Executive Allowances	1.42	0.702867
Mean VIF		1.26

4.1.2 Panel Unit Root Tests

Most economic variables are usually non-stationary in nature and prior to running a regression analysis. Unit root tests were thus conducted using the LLC test to establish whether the variables were stationary or non-stationary. The purpose of this is to avoid spurious regression results being obtained by using non-stationary series. Results in Table 4.3 indicated that all variables are stationary (i.e.absence of unit roots) at 5% level of significance.

Table 2: Unit Root

Variable Name	Statistic(Adjusted)	P-Value	Comment
Risk Taking	-6.51485	0.000	Stationary
Executive Allowances	-1.66840	0.0476	Stationary

4.3.3 Heteroskedasticy Test

Modified wald test was used to test for heteroskedasticity. The null hypothesis in the test is that error terms have a constant variance (i.e. should be Homoskedastic). The results in the Table 4.4 below indicate that the error terms are homoscedastic, given that the p-value is more than the 5% (0.07).

Table 3: Heteroskedastic Test

	Modified Wald test for group wise heteroskedasticity in fixed effect regression model
	H0: sigma(i)^2 = sigma^2 for all i
chi2 (11) =	323.76
Prob>chi2 =	0.07

4.3.4 Normality Tests

The test for normality was first investigated using the graphical method as indicated in figure 2. The results in the figure indicate that the residuals are normally distributed.

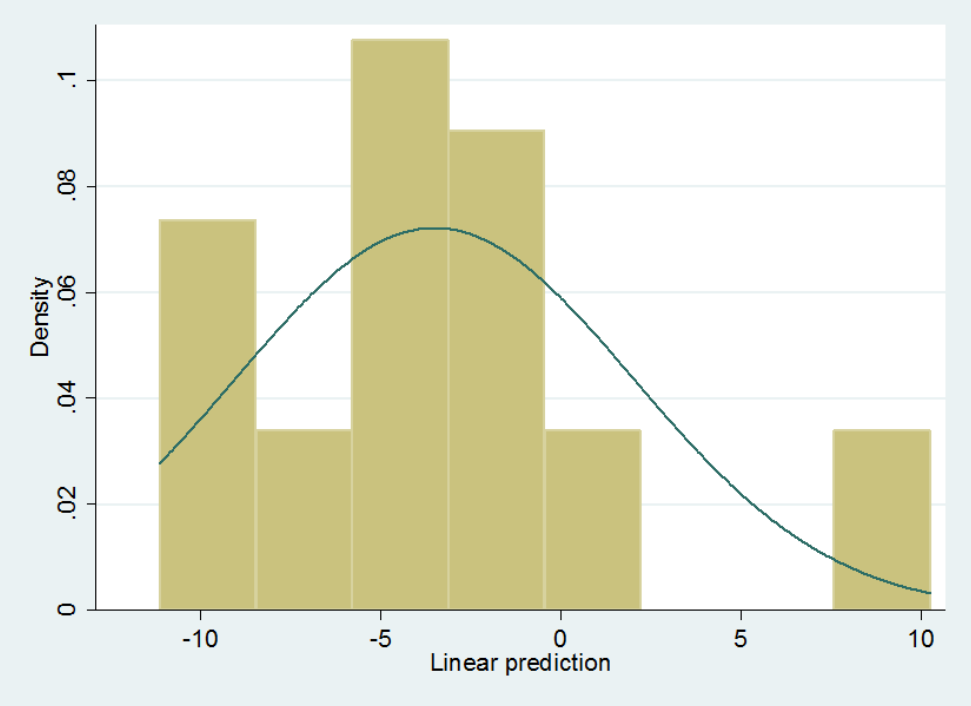

Figure 2: Normality Distribution

To further verify the above results, Jarque-Bera test which is a more conclusive test than the graphical method was conducted. The results are as presented in table 4. The null hypothesis under this test is that the disturbances are not normally distributed. If the p-value is less than 0.05, the null of normality at the 5% level will be rejected. Given that the p-value is less than 5% for the residual, the null hypothesis is rejected and thus the conclusion that the residuals are normally distributed.

Table 4: Jarque-Bera test

	Risk taking	Exe.Share ownership	Exe Fixed salary	Executive allowances	Exe Annual bonuses
Jarque-Bera	7.870817	6.853443	5.349707	0.555680	3.180141
Probability	0.019538	0.032493	0.068917	0.757418	0.203911
Observations	61	61	61	61	61

4.3.5 Autocorrelation

To establish whether or not the residual is serially correlated over time, Wooldridge test for autocorrelation was conducted. The null hypothesis is that no first order serial /auto correlation exists. The results are as indicated in Table 4.6 below and therefore the null hypothesis of no autocorrelation is accepted and therefore residuals are not auto correlated (p-value=0.1010).

Table 5: Autocorrelation Tests

Wooldridge test for autocorrelation in panel data
H0: no first-order autocorrelation
F(1, 30) = 2.864
Prob> F = 0.1010

4.2 Exploratory Data analysis

Data analysis began with the exploration of the study data. Exploration study analysis examined heterogeneity across the firms and over time. Exploratory data analysis was done using graphs to examine the trend of risk taking within and across the firms. Figure 2 shows the empirical growth of risk taking over the 5 years. The empirical growth plot reveal that for most firm's risk taking trend has been on the fluctuating over time this could be attributed to environmental factors and the changing regulatory environment over this period.

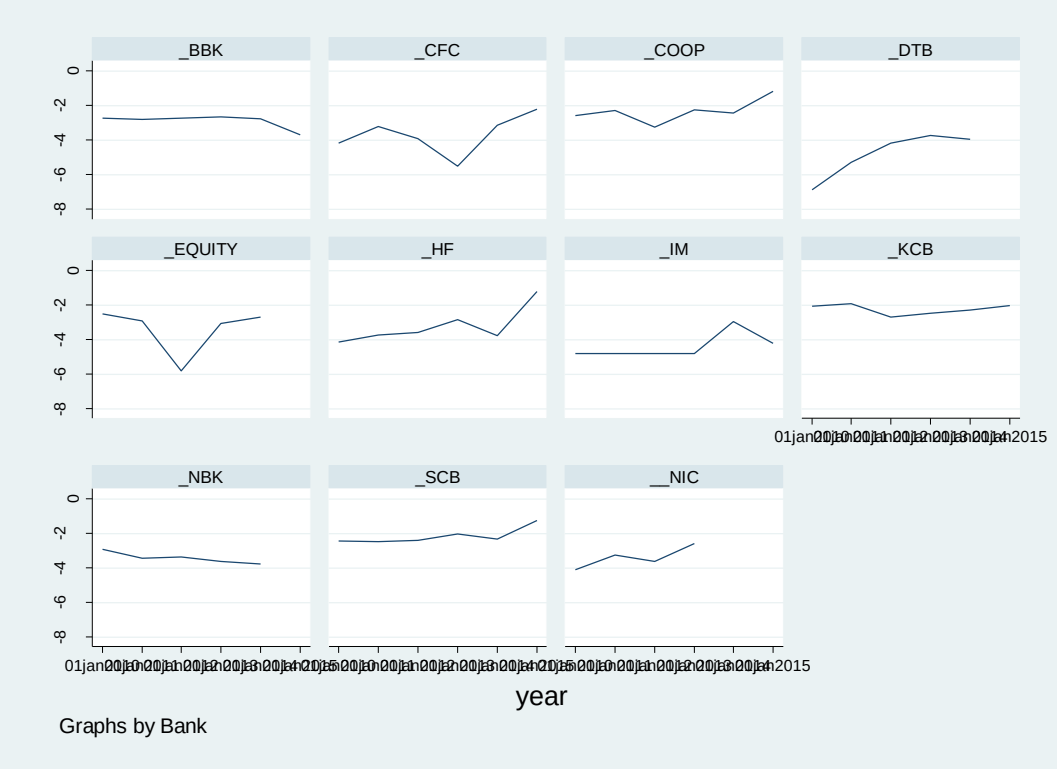

Figure 2 Exploratory Data Analysis

4.3 Correlation Analysis

Correlation coefficient values ranging between -1 and 1 measures the degree to which two variables are linearly related with the higher magnitude indicating higher degree of association between two variables. Adejimi, Oyediran and Ogunsanmi (2011) observed that that a

correlation coefficient of magnitude 0.3–0.5 shows a medium linear dependence between two variables while 0.5 to 1.0 shows a strong linear dependence.

The correlation results in Table 6 above indicate that Executive allowances were negatively associated to risk taking (r= -0.238, p=0.063).

Table 6 : Correlation

Correlation

Probability	Risk Taking	Share Ownership	Fixed Salary	Allowances	Annual Bonuses
Risk Taking	1.000000				

	0.4569	0.0109	-----		
Exe.Allowances	-0.238903	-0.270677	-0.495063	1.000000	
	0.0637	0.0349	0.0000	-----	

4.4Test for Fixed and Random Effects

When performing panel data analysis, one has to determine whether to run a fixed effects model or a random effects model. Whereas the fixed effect model assumes firm specific intercepts and captures effects of those variables which are specific to each firm and constant over time, the random effect model assumes that there is a single common intercept and it varies from firm to firm in a random manner (Baltagi, 2005). To determine which of these two models is appropriate, coefficients were estimated by both fixed and random effects. Haussmann's specification test (1978) was used to determine whether fixed or random effect should be used. Depending on the nature of αi , two models can be distinguished, first is the Random Effect Model which assumes that αi are random variables uncorrelated with vit. The second model is the Fixed Effects Model which assumes that the αi are individual fixed parameters. The results of both the random and fixed effects model are presented in the table7 and table 8 respectively.

Table 7: Random Effects Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Exe.Fixed Allowances	-0.340626	0.163437	-2.084148	0.0434
LN_X3(-1)	-0.208777	0.204147	-1.022680	0.3125
C	-10.79776	1.831242	-5.896413	0.0000
	Effects Specification			
			S.D.	Rho

Cross-section random		0.262373	0.1012
Idiosyncratic random		0.781886	0.8988

Weighted Statistics

R-squared	0.400993	Mean dependent var	-2.572490
Adjusted R-squared	0.284114	S.D. dependent var	0.969457
S.E. of regression	0.807351	Sum squared resid	26.72446
F-statistic	3.430833	Durbin-Watson stat	1.885004
Prob(F-statistic)	0.004140		

Unweighted Statistics

R-squared	0.472655	Mean dependent var	-3.165766
Sum squared resid	28.70348	Durbin-Watson stat	1.755039

Table 8: Fixed Effects Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Exe.Fixed Allowances	-0.298443	0.198314	-1.504902	0.1425
Ln_X3(-1)	0.055183	0.282628	0.195248	0.8465
C	-5.878363	14.22044	-0.413374	0.6822

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.651816	Mean dependent var	-3.165766
Adjusted R-squared	0.449645	S.D. dependent var	1.053954
S.E. of regression	0.781886	Akaike info criterion	2.627748
Sum squared resid	18.95171	Schwarz criterion	3.354317
Log likelihood	-46.69370	Hannan-Quinn criter.	2.904430
F-statistic	3.224078	Durbin-Watson stat	2.226267
Prob(F-statistic)	0.002056		

4.4.1 The Haussmann Test for Model Effect Estimation

The Hausman test was employed to determine the most suitable model for this study. The null hypothesis is that the fixed effect model is appropriate and the alternative hypothesis is that Random effect estimation models is suitable tested at 5% significance level. The Chi-square test statistic is 10.703576 with an insignificant probability of 0.2191 which means that the null hypothesis is rejected in favor of the Random effects model. Therefore, we accept the random effects model as suitable for this study. The Haussmann test results were presented in table 9

Table 9: Haussmann test

Correlated Random Effects - Hausman Test

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	10.703576	8	0.2191

4.5 Panel Regression Analysis

The regression model helps to explain the magnitude and direction of relationship between the variables of the study through the use of coefficients like the beta coefficient and the level of significance.

The results presented in table 9 presented the fitness of model used of the regression model in explaining the study phenomena. Share ownership, executive fixed salary, executive allowance and executive annual bonuses were found to be satisfactory variables in explaining risk taking. This is supported by coefficient of determination also known as the R square of 40 %. This means that Share ownership, executive fixed salary, executive allowance and executive annual bonuses explain 40 % of the variations in the dependent variable which is risk taking. This results further means that the model applied to link the relationship of the variables was satisfactory.

In statistics significance testing the p-value indicates the level of relation of the independent variable to the dependent variable. If the significance number found is less than the critical value also known as the probability value (p) which is statistically set at 0.05, then the conclusion would be that the model is significant in explaining the relationship; else the model would be regarded as non-significant.

Table 9 provides the results on the analysis of the variance (ANOVA). The results indicate that the overall model was statistically significant. Further, the results imply that the independent variables are good predictors of performance. This was supported by a F-statistic 0f 3.430 and a p value (0.004) which was less than the conventional probability of 0.05 significance level.

The constant C had a coefficient of -10.8 with a significant probability value of 0.0000 which is significant at 1 percent level of significance. This therefore means that the independent variables jointly have a negative slope with beta.

4.5.1 Executive Allowances and risk taking

Table 10 provides Regression of coefficients results .Executive Allowances and risk taking were negatively and significantly related (r=- -0.340626, p=0.0434), thus an increase in one unit of executive allowances led to a decrease of risk taking by 0.340626 units.

This mirrors Massa and Patgiri, (2009) whose Empirical evidence on fund performance suggests that higher incentives correlate with riskier investment strategies as well as with superior performance (Agarwalet al., 2009; Massa and Patgiri, 2009).

Garen (1994) disagrees with our results in that firms with higher levels of risk (as measured by betas from a regression of firms' return on the market return) paid their executives more in salary and less in incentive payments.

Table 4.11: Random Effects Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Exe.Fixed Allowances	-0.340626	0.163437	-2.084148	0.0434
C	-10.79776	1.831242	-5.896413	0.0000
	Effects Specification			
			S.D.	Rho
Cross-section random			0.262373	0.1012
Idiosyncratic random			0.781886	0.8988
	Weighted Statistics			
R-squared	0.400993	Mean dependent var		-2.572490
Adjusted R-squared	0.284114	S.D. dependent var		0.969457
S.E. of regression	0.807351	Sum squared resid		26.72446
F-statistic	3.430833	Durbin-Watson stat		1.885004
Prob(F-statistic)	0.004140			
	Unweighted Statistics			
R-squared	0.472655	Mean dependent var		-3.165766
Sum squared resid	28.70348	Durbin-Watson stat		1.755039

$Y = \alpha + \beta 1X1 - \beta 2X2 - \beta 3X3 - \beta 4X4 + \varepsilon$

Where: Y = risk taking

α = the Y intercept;

X_1 = executive allowances

ε = error term which is assumed to be normal in distribution with mean zero and variance (б)

Overall model will be

Y = -10.79776 -0.340626 executive allowance

5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

5.1.1Executive Allowances

The third objective of the study was to determine the effect of other executive allowances on risk taking among the listed commercial banks in Kenya.

Regression analysis indicated that Executive Allowances and risk taking were negatively and significantly related. The hypothesis results indicated that there is a significant relationship between other executive allowances on risk taking among the listed commercial banks in Kenya.

5.2 Conclusion of the Summary

Banks might also be advised to increase the executive allowances of their executive staff as results show that executive allowances have a negative but significant effect on risk taking. Banks thus should entice their staff with huge allowances expecting a decrease in risk.

5.4 Recommendations of the Study

The study recommendations are in line with the objectives, findings and conclusions of the study.

5.4.3 Executive Allowances

The study recommended that banks should entice their staff with huge allowances as this will decrease risk.

5.5 Suggested Areas for Further Study

The study sought to assess the effect of executive allowances on risk taking among listed commercial banks in Kenya therefore, another area for further studies could consider the effect of executive compensation on risk taking among other sectors.

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