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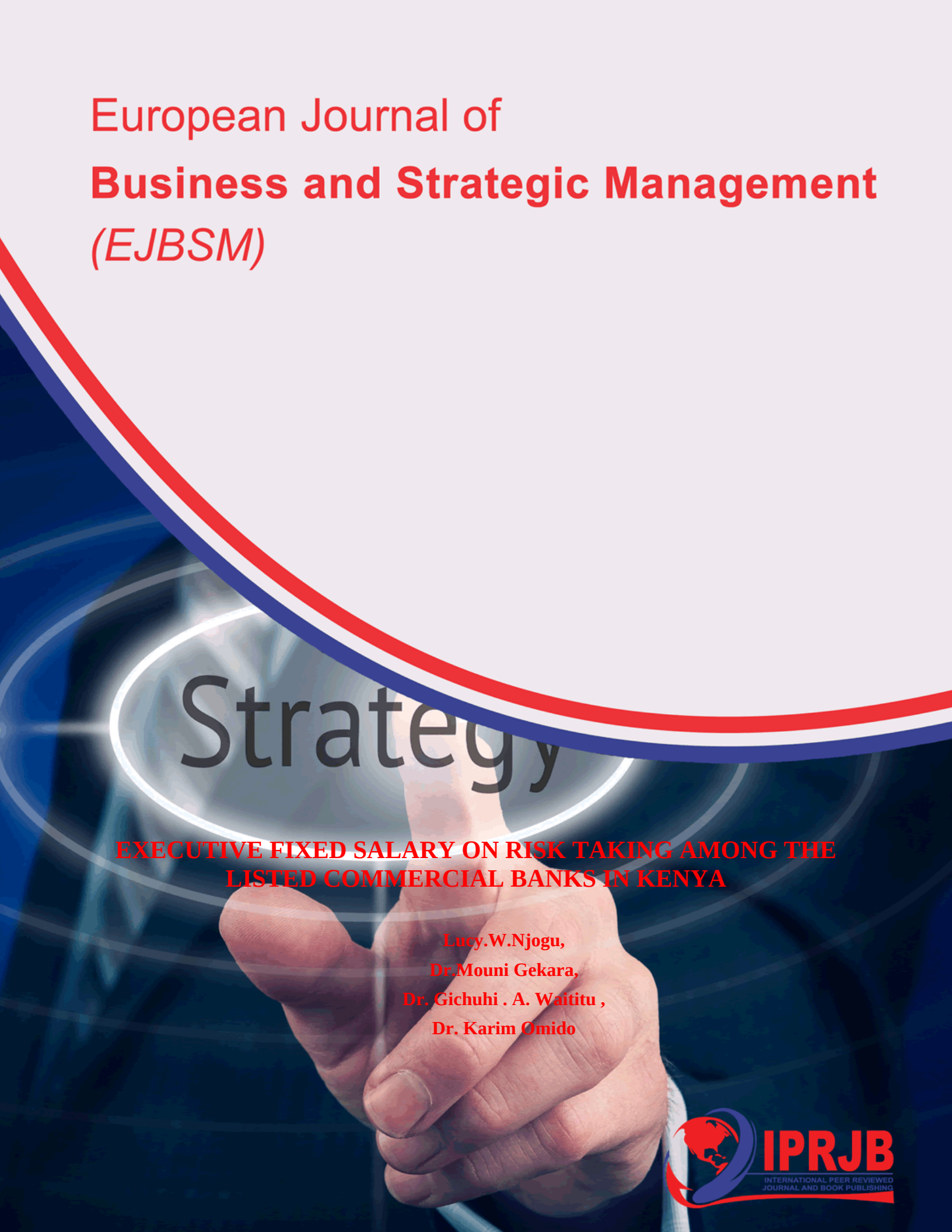

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EXECUTIVE FIXED SALARY ON RISK TAKING AMONG THE LISTED COMMERCIAL BANKS IN KENYA

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Abstract

Purpose: The purpose of this study was to determine the effects of executive fixed salary on 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 the results indicated that Regression analysis indicated that Executive Fixed Salary and risk taking were negatively and significantly related.

Policy recommendation: The study recommended that banks might want to raise their executive salary bases on their executive staff as this will automatically lead to decreased risk in banks.

Keywords: *executive fixed salary, risk taking*

1.0 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.

The bursting of the dotcom bubble in 2000 and the ensuing corporate scandals triggered a collapse of well-known companies such as Enron, WorldCom, and Adelphia, resulting in massive destruction of shareholder wealth as well as damage to other stakeholders. The end of a housing bubble and the subprime debacle led to a shutdown of the credit markets and the failures of venerable financial institutions such as Lehman Brothers and Merrill Lynch. The 2008 financial crisis spread rapidly around the world. These landmark episodes have drawn attention to the high levels of executive compensation, and to the possibility that the structure of executive pay plans may have contributed to the post-1990s bubbles, corporate scandals, and recent financial crisis (Michael et al. 2011).

When analyzing the relationship between firm risk taking and CEO compensation structure, it is important to keep in mind that conventional management compensation schemes motivates risk taking by only looking at return, without regard for the risk(s) accepted in generating it (Segerström, 2008). The same author then further argues that this incomplete approach regarding executive compensation can be seen as a reason for the subprime lending binge, which in retrospect has been identified as one partial cause for the financial meltdown during the recent financial crisis. Since the recent economic crisis originated primarily from the financial industry, and then in later stages developed into a more widespread economic crisis, it is the executive compensation practices in the financial sector that have been the most criticized (Segerström, 2008).

Core and Guay (2009) and Mehran and Rosenberg (2008) find various links between managerial compensation and financial firms' risk-taking behavior. Recently, the four-major federal bank regulatory agencies—the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC)—jointly issued final guidance on incentive compensation. The goal of the guidance is to prevent two kinds of behavior by banks: pursuing short-term profits at the expense of the long-term financial health of the organization, and taking imprudent or excessive risks that could jeopardize the safety and soundness of the organization (Jian, Kent and Todd, 2009).

In the Kenyan environment, the executive remuneration has not come under massive spotlight perhaps due to the nature of CEO compensation. The Kenyan Companies Act sets the general framework for financial accounting and reporting by all registered companies in Kenya, and stipulates the basic minimum requirements with regard to financial reporting. Due to the limited details of the Act, financial reporting and regulation are supplemented by pronouncements of the Institute of Certified Public Accountants Kenya (Barako, et al 2006).

Unlike in the US, where publicly listed firms are required to disclose information on top five executives' compensation, Kenyan listed firms have typically publicly disclosed only aggregated total compensation of a firm's board of directors. This compensation is limited to cash compensation as share option issues have not come into play yet as such the NSE disclosure on shares is limited to bonus and rights issues to the general investing public (Muriuki, 2005).

According to disclosures on the annual reports of listed companies, CEO compensation in the Kenyan listed companies can be divided into salaries, allowances, cash bonuses and fees for services as directors. Another key benefit obtained by directors is the ease of access to loans with all the listed companies having advanced loans to their directors. In view of the absence of stock option advancements to the executive as a major incentive, the relationship between stock performance and CEO compensation may be weak as the stock market performance is not a determinant of the level of executive pay. This is more so given that for most listed companies the payment of executives may not be material in amount and is insignificant in its impact on price and as such it is not subjected to the materiality rule (Muriuki, 2005)

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

i. To establish the effect of executive fixed salary 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.

Donaldson (1990) criticized the agency theory dominance in terms of methodology individualism, narrow-defined motivation model, regressive simplification, disregarding other research, ideological framework, organizational economics and corporate governance's defensiveness.

Focus of agency theory's studies is individual consistent with rational, economic model of human behavior. However, absolute explication of every organizational activity should not be considered as equivalent to individual activity and that represents essential critic of structuralism.

It is extremely important to stress that Williamson's axiom about opportunistic agent's behavior over time has gained many different forms and interpretations. Williamson (1985) identified opportunistic behavior of the minority of individuals, the not majority. "Individual sometimes acts opportunistically and trustworthiness is hardly ex ante transparent. Therefore, it is compulsory to conduct ex ante screening and develop ex post assurance mechanisms or, in contrary, opportunistic individual will exploit circumstances towards less opportunistic individual." Since organizations cannot completely identify and eliminate opportunism, the fundamental proposition is that opportunism is possible and therefore control mechanisms are initiated. However, it is important to stress out that even in circumstances of highly specific assets, where the probability of opportunism is extremely high, there are individuals who will give priority to cooperation and trust and will not initiate opportunistic behavior (Hill, 1990).

This theory is relevant to our study in that it explores the role of the principal in this case the directors or other executives in relationship to the firm risk taking behaviour of the bank. This theory further envisages the role of directors as the sole proprietors of the firm's risk taking behaviors.

2.2 Conceptual framework

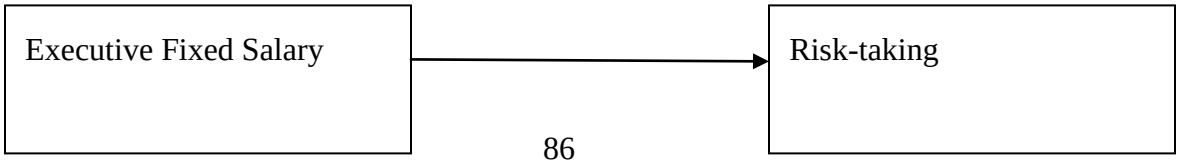

Figure One: Conceptual Framework

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 Fixed Salary	1.4	0.715789
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 fixed Salary	-6.89990	0.000	Stationary

4.1.3 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

4.1.4 Normality Tests

The test for normality was first investigated using the graphical method as indicated in figure 1. The results in the figure indicate that the residuals are normally distributed.

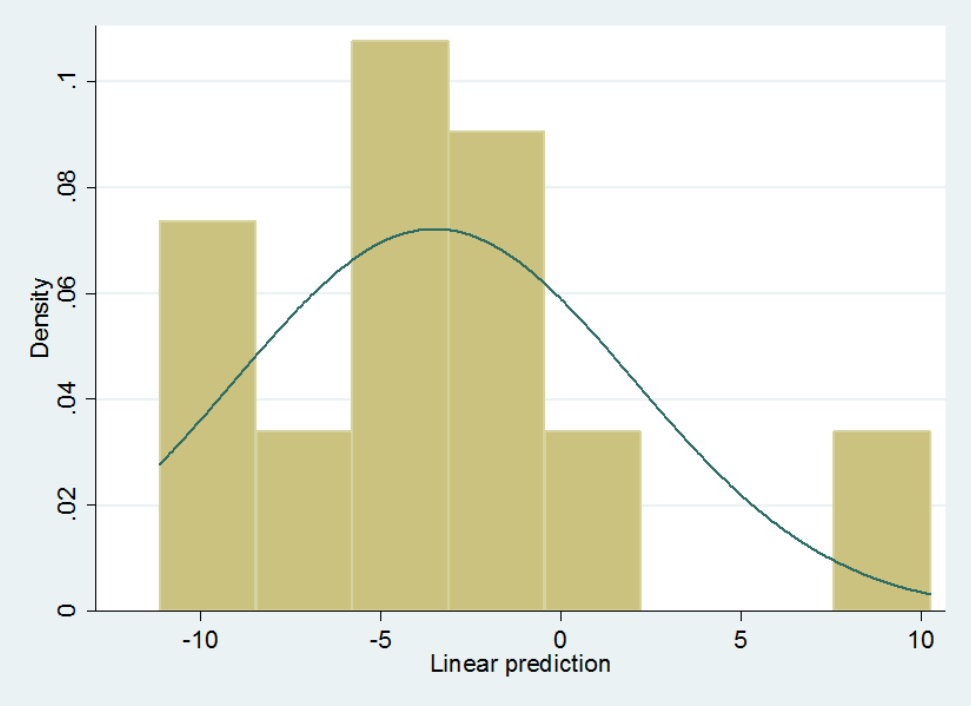

Figure 2: Normality Distribution

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.Shareownership	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

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4.1.5 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 5 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

4.2Exploratory 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 3 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.

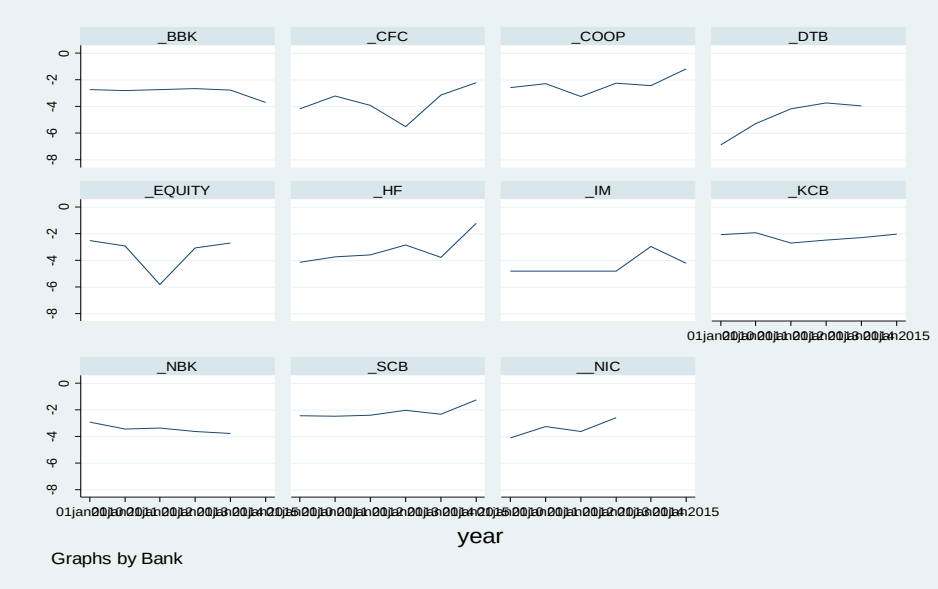

Figure 3:Exploratory Data Analysis

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 share ownership was positively associated to risk taking among commercial banks listed in NSE (r= 0.061, p=0.638). Similarly, executive fixed salary, was negatively associated to risk taking (r=-0.097, p=0.456). Executive allowances were negatively associated to risk taking (r= -0.238, p=0.063). Also, executive annual bonuses had a negative association to risk taking (r= -0.486, p=0.0001).

Table 6: Correlation

Correlation

Probability	Risk Taking	Share Ownership	Fixed Salary	Allowances	Annual Bonuses
Risk Taking	1.000000				
Exe.Fixed Salary	-0.097039	0.323776	1.000000		

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 table 7 and table 8 respectively.

Table 7: Random Effects Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Exe.Fixed Salary	-0.509771	0.242056	-2.106008	0.0414
LN_X2(-1)	0.046977	0.242663	0.193590	0.8475
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 Salary	-0.749848	0.331873	-2.259440	0.0310
Ln_X2(-1)	-0.176179	0.304278	-0.579006	0.5668
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

4.7 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 11 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.

4.7.2 Executive Fixed Salary and risk taking

Table 4.11 provides Regression of coefficients results. Executive Fixed Salary and risk taking are negatively and significantly related (r = -0.509771, p=0.0414). Thus an increase in one unit of executive salary led to a decrease of the dependent variable risk taking by 0.509771units.

Swagerman and Terpstra (2007) also agrees with our findings when they investigated executive pay structure in Netherlands, the study concluded that base pay is still an essential component of executive compensation due to its being risk free.

These results agree with Scholt and Smit (2012) who carried out a study on executive remuneration and company performance in South Africa. The study found that there was a strong relationship between executive remuneration and some company performance indicators, such as total assets, turnover and share price for companies listed on the AltX.

However the results disagree with , Gathua et al (2013) who examined the relationship between executive compensation and risk taking among commercial banks in Kenya, The study found that executive compensation has insignificant relationship with risk taking among commercial banks in Kenya.

Table 10: Random Effects Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Exe.Share Ownership	-1.730807	0.940152	-1.840987	0.0729
Exe.Fixed Salary	-0.509771	0.242056	-2.106008	0.0414
Exe.Fixed Allowances	-0.340626	0.163437	-2.084148	0.0434
Exe.Annual Bonuses	-0.623036	0.350704	-1.776529	0.00831
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
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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 fixed salary

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

Overall model will be

Y = -10.79776 -1.730807 executive fixed salary

5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

5.2.2 Executive Fixed Salary

The second objective of the study was to establish the effect of executive fixed salary on risk taking among the listed commercial banks in Kenya.

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

5.3 Conclusion of the Summary

The study also concludes that there is a negative and significant relationship between executive fixed salary and risk taking. Thus, banks might want to raise their executive salary bases on their staff as this will automatically lead to decreased risk.

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.

5.4.2 Executive Fixed Salary

It was recommended that banks might want to raise their executive salary bases on their executive staff as this will automatically lead to decreased risk in banks.

5.5 Suggested Areas for Further Study

The study sought to assess the effect of executive compensation 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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