

**THE RELATIONSHIP BETWEEN FINANCIAL PERFORMANCE AND
EXECUTIVE COMPENSATION OF COMMERCIAL BANKS IN KENYA**

BY

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DECLARATION

This is my original work and has not been presented for award of a degree in any other university or any other institution of higher learning.

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LIST OF ABBREVIATIONS

BOD-Board of Directors

CBA- Commercial Bank of Africa

CBK-Central Bank of Kenya

CEO-Chief Executive Officer

CFO-Chief Financial Officer

CMA-Capital Markets Authority

DTB-Diamond Trust Bank

HFCK-Housing Finance Company of Kenya

KCB-Kenya Commercial Bank

NSE-Nairobi Securities Exchange

ROA-Return on Assets

ROE-Return on Equity

UK-United Kingdom

USA-United States of America

VP-Vice President

ABSTRACT

At the centre of shareholder wealth maximization has been the need to align the efforts of management and executives to those of the shareholders. This has led to design of various executive compensation schemes to reward management and motivate them to work harder. Over the years there has been need to ascertain the determinants of executive compensation paid to management and the relationship if any to financial performance and hence if the conflict of interest is minimized and their interests aligned then both management and shareholders will benefit from an improved financial performance of their corporation. The study sought to determine the relationship between financial performance and executive compensation of commercial banks in Kenya where it considered a functional form relationship between the financial performance as measured by return on equity and executive compensation using a regression model which found a positive but insignificant relationship between financial performance and executive compensation of commercial banks in Kenya thereby suggesting that accounting measures of performance like return on equity are not key determinants of executive compensation for commercial banks in Kenya. This suggests that commercial banks should incorporate other factors like risk, size of the bank, skill, quality and experience of the executives to determine their optimal compensation needed to align their interests to those of shareholders.

Keywords: Executive Compensation, Financial performance, Commercial banks

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Executive compensation has been an ever ending highly controversial issue in most parts of the world especially Europe and USA. In Kenya it is just a matter of time before the new rules on disclosure of executive remuneration components by CMA and also the CBK rules to cap salaries of the executives to the size of their operations become a reality and opens up otherwise outrageous compensations earned by listed corporation's executives to the general investing public and to the increasingly watchful financial press.

This study is informed by otherwise outrageous benefits management takes home at the expense of creating shareholder wealth which is the most important and widely accepted goal of the firm in finance literature. According to Crystal (1991), compensation paid to the top executives of publicly traded corporations is a politically sensitive area with critics claiming that amounts paid to executives are too high. The levels of compensation in all countries have been rising dramatically over the past decades. Not only is it rising in absolute terms, but also in relative terms. Gabaix & Landier (2008) established that the compensation of other senior executives has risen more rapidly than that of rank and file workers but has not kept pace with CEO pay. A reason for these huge increases is a result of the addition of this risky pay which necessitated an increase in compensation of the risk averse executives.

The basic question on the minds of the investing public and shareholders once the financial results are announced or published is whether the agents of corporations who

are the managers/directors acted in the best interest of the corporations they work for and by extension the shareholders.

Different mechanisms of mitigating agency conflict have been in existence for many years but using executive compensation has been the greatest puzzle for many financial analysts, researchers and shareholders at large and whose relationship which is ideally expected to be directly related to their output has proved to be otherwise.

Also coupled with a limited pool of able, experienced and seasoned 'CEO materials' and top management skills, companies and especially Kenyan banks have continued to reward their CEOs and top management with quite impressive and internationally competitive executive compensation to attract and retain them in their respective organizations. According to Kay (1998), corporations on the flip side have argued that they need to pay well to attract, retain and motivate quality people.

Warren Buffet in a letter to Berkshire Hathaway shareholders in 2005 wrote that 'too often, executive compensation in the US is too much is ridiculously out of line with performance. The upshot is that a mediocre-or-worse CEO –aided by his handpicked VP of human relations and a consultant from the ever –accommodating firm of Ratchet, Ratchet and Bingo-all too often receives gobs of money from an ill-designed compensation arrangement. This touches on both financial performance parameters and corporate governance mechanisms in place especially an independent compensation committee of the Board of Directors'

1.1.1 Financial Performance

This is a measure of the extent the corporation has attained its goals and objectives thereby meeting the needs of all stakeholders and specifically shareholders. According to Bien (2002), financial performance is the economic financial condition of an entity in a given time, which is also known as financial effectiveness.

The variables against which financial performance can be measured could be accounting based or market based. These may take the form of absolute figures, ratio, and descriptions of various dependencies among the performance parameters. Accounting based measures are easily calculated and derived from the financial reporting process like the earnings before tax, earnings after tax, earnings per share, return on assets, return on equity etc however caution should be applied to guard against manipulation of the financial statements by management in a bid to overstate their earnings. According to Jeff Kozan, executive compensation consultant with Towers Perin, Canada, accounting based measures is result based, consider both revenue and expenses and determine the investments needed to generate profits

Market based measures are derived from the financial markets where the firm's financial assets are trading and are based on the perception of the investors both potential and current investors on how they react to the various information released to the market by the corporation and other market players like analysts. It tends to be less susceptible to manipulation though it depends to some extent to the accounting based measures e.g. share prices, dividends.

1.1.2 Executive Compensation

Executive compensation is pay received by an officer of a firm, often as a mixture of salary, bonuses, and shares of and/or call options on the company stock (Bebchuk & Grinstein, 2005, Murphy, 1999), paid expenses (perks) or insurance. It refers to the benefits and remuneration accruing to top management of a corporation mostly the Board of Directors including the CEO.

The various components of executive compensation include a basic salary, bonus, stock options, and grant of shares, pension, severance pay and perquisites though the last three have not been covered extensively in literature and have been camouflaged in most executive compensation contracts (Bebchuk & Fried,2004;Kuhnen & Zwiebel 2009). Other benefits include employee benefits and pension ideally configured to take into account government regulations, tax law, the desires of the organization and the executive, and rewards for performance.

According to the Central Bank of Kenya report (2012), commercial banks of Kenya have a great disparity in their remuneration system depending on their compensation philosophy. The report found out that candidates with most sought after specialist skills were in a position to command higher levels of compensation. On the other hand, inefficient and poor performing managers have not been equally penalized and disciplined by both the firm and market mechanisms compared to the hype and publicity the otherwise perceived to be hardworking executives have received. This could mean existence of a weak and toothless corporate labor market which is unable to deal with lazy and inefficient top managers.

The problem of excessive executive pay especially among listed companies has been seen as immoral by ethics proponents with little or no repercussions for their lazy counterparts. In this paper for ease of comparison and objectivity given the limited data, we will use compensation received rather than that due for the year. Executive compensation in this study will be measured by the director emoluments/remuneration/bonus and fees as reported in the audited accounts and received by the executives in a given year.

1.1.3 Financial Performance and Executive Compensation

Ideally, executive compensation and financial performance are perfectly correlated, but associative studies on executive compensation and performance have yielded mixed results. The executives who build real value in the company they manage should be paid handsomely well but not excessive, hence a level which is able to attract, maintain, and motivate such skilled managers who will enable the firm achieve its objectives and goals in the long term.

Murphy (1999) provides a general overview of the literature, methodology and issues in executive compensation, starting from the influential study of Jensen and Murphy (1990), which first identified the pay-performance puzzle and reported that there is little relationship between executive pay and company performance. Main et al (1996), Izan, Sidhu and Taylor (1998), and Benito and Conyon (1999) have confirmed these low pay performance sensitivities. Most studies have found out that there exists a positive relationship between cash compensation and financial performance in terms of profitability measures. The purpose of executive compensation is to attract and retain

skilled labor. It also encourages employees to act in accordance with all the stakeholders' desires and thus reduce possible conflicts of interest within the organization.

Executive compensation should be designed in a way that affects employees positively and should fulfill three criteria according to Kaplan & Atkinson (1989). The executive compensation should be competitive in terms of size in order to attract and keep the best employees; Incentive programs shall communicate and strengthen the main objectives of the company by attaching flexible compensation to performance; Flexible compensation shall encourage a performance oriented corporate climate by observing and rewarding good performance

1.1.4 Commercial Banks in Kenya

The CBK which is the regulatory authority of the banking sector has classified all the banks into three major classifications based on a risk weighted average of their asset size, capital, deposits and market share. The classifications of the banks include large banks, middle sized banks and small banks and there are a total of 43 banks as per CBK bank supervision report of 2013

The list of the commercial banks in Kenya as of 31st December, 2013 is in appendix 1.

On a wider scale using a cross industry comparison the financial sector and specifically the banking sector has the highest cash compensation to its executives among the listed companies at the NSE and also across the whole economy due to the specialized skills required and also the high risk as a result of operating in a highly regulated environment. (PWC CEO Survey, 2013; Grant Thornton Financial Executive Compensation Survey,

2012 and Central Bank of Kenya report, 2012)

1.2 Research Problem

A conceptual framework portrays the relationships and the type of relationships among the concepts. The conceptual framework below illustrates the relevant concepts in the study and the type of relationship (positive or negative) between the concepts.

In the Kenyan banking industry banks which are large and are performing well have continued to pay their executives highly. The executives not only take home a high base salary and performance related bonus but also other myriad of perks, pension and severance packages. In the wake of stiff competition and the need to sustain growth in profitability commercial banks have lost some of their top managers to their rivals and as a result the salaries needed to 'poach' and maintain them may be above the average for such a position and this has left banks with high wage bills eating into their profitability further.

The study of the relationship between financial performance and executive compensation and has been widely discussed in both corporate governance and finance circles especially in the last 2-3 decades. Banker & Datar, (1989) reported that the relative importance of various factors used to measure the performance of agents should be related to how well each measure informs the principal about the agent's actual performance.

According to Ellig (2002), executive compensation or executive pay is composed of the financial compensation and other non-financial awards received by an executive from their firm for their service to the organization. For the Kenyan banks, the most prevalent

form of executive pay is salary, bonuses and issue of stock. This relationship between executive pay and financial performance should ideally be positively correlated with an increase in financial performance leading to an increase in executive pay though various studies have yielded conflicting results.

Studies that have been done on executive compensation and financial performance in Kenya and Africa at large and the numerous studies done in USA, Europe and Asia have yielded different conclusions hence there exists still a knowledge gap on how financial performance is related to executive compensation.

In light of the mixed results in theory and empirical evidence with regard to the relationship between financial performance and executive compensation, the study then intends to answer the question “What is the relationship between financial performance and executive compensation of Commercial Banks in Kenya”

1.3 Research Objective

To establish the relationship between financial performance and executive compensation of Commercial Banks in Kenya

1.4 Value of the Study

The study will assist in determining the components of the various executive compensation packages and their impact on financial performance for the commercial banks in Kenya.

The study will highlight other beneficial components of executive compensation packages which have worked and have been successfully implemented in other parts of the world to varying degrees of success but with special reference to the unique circumstances and characteristics of our Kenyan banking sector and capital markets.

The findings of this study will help the board remuneration committees and compensation consultants in Kenya to be able to formulate executive compensation packages consistent with shareholder wealth maximization for the benefit of both management and shareholders. This study through its findings will compare with other findings from other studies and help narrow the existing research gaps still existing in the area of executive compensation and financial performance.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews and discusses the various schools of thoughts as identified in literature to explain the relationship if any between financial performance and executive compensation of the commercial banks in Kenya

2.2 Theoretical Review

These are theories explaining the relationship between financial performance and executive compensation.

2.2.1 Agency Theory

Jensen & Meckling (1976) argue that managerial agency costs lie at the centre of executive compensation. Agency theory whose conceptual framework reduces the corporation to two participants i.e. shareholders and managers has suggested that employees and managers can be self-interested and hence like any agent their actions may conflict with that of the principal. Owing to widely dispersed ownership, the agent may pursue activities that benefit him rather than the firm's owners. Eseinhardt (1989) defines agency theory as an attempt to describe a relationship where one party (principal) delegates work to another (agent) and to an extent it is concerned with resolving the problem in a relationship with conflict of interest and risk sharing when the attitude towards risk diverges

According to Lang & Stulz (1994), they found out that diversification activities reduce management specific risk while strengthening its job security. They concluded from their

study that the value of shareholder returns is greater in undiversified companies and also the value of the company is reduced as they diversify further.

Jensen (1986, 1989) says that managers of low growth and high free cash flow companies in particular are involved in non value maximization activities. Also these managers will tend to increase their perquisite consumption and compensation as well as earnings management and creative accounting at the expense of shareholder wealth maximization according to Jensen, Shleifer & Vishny (1989). They argued further that if by using executive compensation to align manager's interest to those of the shareholders is effective then there should be a positive relationship between managerial compensation and firm performance. With the exception of stock options, current evidence indicates that there is small sensitivity for pay to performance. Agency theory may be considered as a theoretical extension of managerialism. A firm's owners are called the principals and the hired executives are called the agents. Agency theorists hold that agency costs are a necessary evil that comes with the advantages of modern corporations.

Prospect theory focuses on the executive's loss aversion rather than the risk aversion postulated by the agency theory according to Wiseman & Gomez-Mejia (1998). To avoid losses or missing goals or targets, the executive is actually willing to take risks but once they achieve their performance goals or targets, the benefit of the executive increasing performance is offset by the possibility of falling below target

2.2.2 The Optimal Contracting Theory

The Optimal contracting theory by Michael S. Weisbach is a classic economic theory of executive compensation that is meant to minimize managerial agency costs and maximize shareholder value. It has been further advanced by Core et al. (2003). This could arise as a result of extensive lobbying by non executive and other outside directors who want to maximize shareholder wealth or from competition in labor, capital, products and corporate control markets. According to Lazear & Rosen (1981), a critical assessment of the agency theory shows that its underlying perfect contracting approach suffers the following pitfalls; the socially determined symbolic value that executive compensation could represent and the contextual conditions under which executive compensation is set.

2.2.3 Managerial Power and Governance Theory

This is advanced to large extent by Bebchuk et al. (2002) and asserts that executive compensation determinants are not consistent with shareholder wealth maximization benchmarks. This is because executives have more bargaining power in setting the terms of their employment and compensation contract hence not an arm's length hiring exercise. However, with the threat of the financial press and other watch dogs organizations, they will always seek other ways of hiding their huge perks

Bebchuk & Grinstein (2005) asserts that the Bull Run in the stock markets in the 1990s weakened outrage from shareholders and allowed BODs to increase salient forms of

executive compensation like equity compensation whose disclosure was somewhat hidden among financial statement numbers.

The separation of ownership and control in modern corporations gives top managers almost absolute power to use the firm to pursue their personal objectives as reported by Gomez-Mejia (1994). This can lead to executive pay decisions that benefit the executive regardless of what the organizational outcomes and effects might be on shareholders i.e. the absolute power to increase their compensation levels and reduce the risk of their compensation. In other words, an executive in such a firm is more likely to have a pay package that will increase when firm performance is good and remain at the same level even when the firm performance is poor and this is referred to as managerialism. Tosi et al. (2000) defined managerialism as a concept which is built on the premise that the separation of ownership from control can and does cause divergence of interest between the management and owners and hence the managers will concentrate on maximizing firm size rather than the value of the company and in doing so they get more pay, power and prestige and could result to less or even negative returns for the shareholders.

Governance theorists hold that executives should pursue strategies that will create long-term shareholder value and that they should receive closely related rewards. Executives may feel free to pursue interests that do not coincide with those of the firm's owners, knowing that the owners have a limited ability to influence the executive's rewards. As a result, the executive compensation package may not be effectively linked to performance that creates or maximizes shareholder value. Marginal Productivity and agency theories

are subsets of governance theory that deal with issues arising when the firm's owners are removed from the decision making processes of the executive.

2.2.4 Market Based Theory

Ben-David, Graham & Harvey (2008), Malmender & Tate (2005,2008,2009) point to the fact that failure to have any agreed and scientifically proven benchmark for determining CEO pay could result to a very overconfident CEO being paid highly and hence they may engage in sub optimal behavior from the standpoint of shareholders.

This is consistent with studies by the University of Florida researchers who found that highly paid CEOs improve company profitability as opposed to executives making less for similar jobs. On the other hand, a study by Andersson & Batemann (1997) published in the Journal of Organizational Behavior found that highly paid executives are more likely to behave cynically and therefore show tendencies of unethical performance.

Main et al. (1994), Conyon & Leech (1993) and Greggy et al. (1993) concluded that the underlying objective behind most mergers and acquisitions is that size of the combined firm will be a major factor in determining executive compensation rather than benefits to shareholders of the combined firm. By the very nature of rationality, the need to improve financial performance has continued to determine the level and structure of executive compensation i.e. it has been said that the best motivators are fear and greed and these emotions, or 'animal spirits', characterize the logic behind incentive based compensation and firm performance dictates pay. In determining management rewards or penalties, the remuneration committee or its equivalent BOD committee should determine

measurements and levels of pay with input from the internal auditor and direct conversations from the BOD and lower level management. Rewards to top management should be balanced and pegged to financial performance and should satisfy corporate governance objectives

2.2.5 Marginal Productivity Theory

As argued by Mejia (1994), in equilibrium the executive should receive as compensation his or her value to the corporation and defined this as observed performance of the firm minus what performance would be if the next best alternative executive was at the helm plus the pay that would be necessary to acquire the latter's services. This theory is concerned with predicting pay levels of executives within the context of analyzing the firm's ability to generate profits and maximize productive output. It has made the assertion that the size of the executive pay package reflects the firm's net profits. In a firm where the entrepreneur is the sole owner and functions as chief executive officer, the entrepreneur desires to achieve the highest returns on his investments and this will occur where the marginal cost of production is equal to the market price of the product. At this point the firm maximizes its profits and the executive maximizes his compensation which is equivalent to the profits of the firm.

In practice however, there are no such pure situations and most entrepreneurs borrow capital from outside investors and decision must be made about what share of profits goes to whom. The marginal productivity theory is not a framework for determining the allocation of profits between an executive and others who invest their money. The other assertion is that the size of the executive pay package is proportional to the executive's

marginal revenue product. It is assumed that the executive is hired by the firm and is paid commensurate with his economic contribution. The amount of compensation equals the executive's marginal revenue net product. The practical implication of marginal productivity theory is that both the firm's profitability and the executive's relative economic contribution are pay-level determinants. To some extent, this theory can explain the "star" system that has developed in the hiring of certain chief executive officers and other key executives. These are executives with demonstrated track records of creating shareholder value through their management skills. Such individuals may demand and receive outsized compensation levels compared to others doing the same job because of their potential to influence a firm's future profitability and value and this could be seen in the current corporate world.

2.2.6 Structural and Social Comparison Theories

Structural theory examines executive compensation at the firm level. Structural theory focuses on the "social standards" of pay at different hierarchical levels. According to this theory, organizations attempt to maintain particular salary differentials between the management and subordinate levels to comply with cultural norms of proportionality. Executives can expect to receive a relatively large amount of compensation in a firm that is of a considerable size and where there might be a large number of hierarchical levels. Conversely executive compensation levels would decline in response to the trend towards corporate 'downsizing.'

Closely related to this is the Social comparison theory by O'Reilly et al. (1988) where it is argued that board members use their own pay as a reference point when setting pay of executives. The issue of executive compensation being benchmarked across the industry and with potential competitors has also been researched by many scholars.

2.2.7 Human Capital Theory

Aggarwal (1981) established that under Human Capital Theory, the value of the executive and hence his or her compensation, is based upon his or her accumulated knowledge and skills and the logic behind is that the amount of human capital a worker possesses influences his productivity which in turn influences his earnings. An executive with greater amount of human capital would be better able to perform his job and therefore be paid more

Human capital theorists examine the individual characteristics of the executive in attempting to predict pay levels. These characteristics include factors that are intrinsic to the executive such as his knowledge base. It is possible to calculate a rate of return on investments made in human capital. The amount of human capital acquired by the executive at any given point determines how valuable he is to the firm. This in turn, predicts how much the firm will pay for his services and this is quite common for executives with special skills in the banking industry.

Class Hegemony Theory argues that executives share a common bond and that through the boards composed primarily of CEOs and executives, they are able to pursue their own goals and interests rather than those of shareholders. Gomez-Mejia (1994) noted that

board input is primarily used to legitimize high executive pay reflecting a shared commitment to protect the privileges and wealth of the managerial class (pg 180)

2.2.8 Symbolism and Organization Theories

The symbolism theories of executive compensation held that the executive's power and political influence are the primary determinants of his pay level. Power and politics are of more direct importance to those who make executive pay decisions than the economic elements of firm performance and executive productivity. Two symbolism theories are discussed below: Tournament theory which was put forward by Lazear & Rosen (1981). Tournament theory holds that the amount of compensation received by executives of an organization is similar to tournament winnings. Tournament participants are members of the organization who could ultimately reach the top most post-the chief executive officer.

The prospect of this prize post sends powerful signals throughout the organization that by working harder one may win the number one post. The emphasis is not on whether an executive deserves his amount of compensation, rather the focus is on the motivational properties that executive compensation levels brings to those in the lower level of the organization; Political Strategist and Team Production Theories where political strategist theory tends to ignore the rational justifications of executive compensation. Instead, attention is paid to the executive's ability to cater to the needs of the multiple constituents of the firm such as board members, shareholders, customers, government and the general public. This theory proposes that the level of executive compensation can best be understood by examining how well the executive appeases these various constituent

groups. The amount of skill the executive has in serving as political strategist determines his level of compensation. Team Production Theory is advanced by Blair & Stout (1999) who asserts that BODs act as mediators among all the stakeholders e.g. creditors, shareholders, executives and other employees etc. hence they postulate that compensation arrangements would not be designed to maximize shareholder value but balance the interests of stakeholders. According to Rosen (1982, 1990), the actions of a CEO multiply over the scale of his operations, which allows him to accrue rents in a competitive equilibrium. In a competitive labor market, more talented senior executives are allocated to larger firms since the marginal productivity of their actions is magnified across the lower levels of the hierarchy.

2.3 Determinants of Executive Compensation

According to Core & Mehran (2008), determinants of executive compensation are executive characteristics and ownership structures but ignored performance and board characteristics. Banghojet.al. (2008) however established that in addition to performance and board characteristics, they included executive characteristics such as ownership, education, executive position and tenure.

Feltham & Xie (1994) argue that the most performance measures are incomplete or imperfect representations of the economic consequences of management actions and they used more than one measure of performance unless is perfectly congruent and noiseless. Bonus plans that specifically consider the impact of both transitory items and changes in

accounting policies on the performance measures adopted are believed to be of higher quality than bonus plans that ignore these issues.

Musyoka (2008) established that accounting measures of performance are not key considerations in determining executive compensation among the large commercial banks in Kenya and that size is a key criteria in determining executive compensation as it was significantly but negatively related to compensation. The negative correlation suggests the capping of executive compensation to ensure maximization of returns to shareholders.

Shah et al. (2006) studied a sample of 114 listed companies in Pakistani for the period 2002-2006 and found out that CEO compensation is a function of performance measures, size, corporate governance variables like CEO duality, board independence and board size, ownership structures and concentration, audit committee independence. He found a positive relationship ($t=8.54$, 1% significant level) between total compensation and of the CEO and the size of the firm.

Bizjak, Lemmon & Naveen (2008), Faulkender & Yang (2009) reported that firms benchmark their pay on peer groups to determine levels of executive salary , bonus or option rewards based on the industry and size. Size of the firm is the most important determinant according to Murphy (1999), also through his study he found out a strong relation between CEO cash compensation and firm's revenues for each 5 years period between 1970 and 1996 and is the same across industries. This can be seen to be applicable for the Kenyan banking industry with CEOs and directors of the largest banks in Kenya earning higher pay that the other smaller banks.

According to Grant Thornton Financial Executive Compensation Survey of 2013, executives who are eligible for long-term incentives (cash, stock-based or other), the most common measure for determining payouts was base salary level (66%), followed by more specific company performance measures such as goals and objectives (41%) and discretionary (36%). The use of EBITDA as a performance measure (30%) has also continued to increase.

The principal-agent theory suggests that managerial pay should be related to managerial actions in order to align the insurance motive of the manager with the wealth-maximizing incentive of the shareholders (Jensen, 1986).

Bank risk is an important determinant of management compensation (Evans et al. 1997; Knopf & Teall, 1996; Saunders et al. 1990). The higher a firm's risk exposure, the higher is the risk of firm failure, and board and executives need to be compensated accordingly. The special case about the banking industry is that higher risks are already taken into account by the capital requirements imposed by regulation authority. The more risks a bank is taking, the more equity does it need to secure its risky balance sheet positions.

A number of studies show that company size and changes in size are much more significant determinants of executive pay than measures of shareholder value. Several empirical studies provide evidence for a positive and significant relationship between firm size and compensation. Jensen & Murphy (1990), Conyon & Murphy (2000) carried out studies on managerial compensation they generally found there is a direct relationship between company size and compensation accruing to executives in that as the size

increases so is the compensation especially the cash compensation which includes salary and bonuses. This always causes a conflict of interest as the managers are focused on those activities which will increase growth and the size of the corporation rather than those whose end result is shareholder wealth maximization

According to the PWC (2012) report dubbed The Africa Business Agenda, bank executives also saw their pay last year rise by double digits reflecting how far corporate Kenya is going to retain top talent. This is forcing employers to raise fixed salaries and widen the scope of performance-related pay to include bonuses and shares.

According to the PWC CEO Survey (2013) Companies are offering higher pay as a key talent retention strategy largely seen in the fast-growing industries like banking and telecommunications. It further states that employers are forced to pay hefty salaries and offer lucrative perks to hire and retain the executives they need to stay ahead of the competition in a growing market. The survey showed that 97 per cent of Kenya's business leaders agreed that their firms needed to match the compensation levels of their peers to retain top talent which was above the global and the continent's average of 69 per cent and 79 per cent respectively. The fight to retain key talent comes at a time a section of Kenya's large companies plan to scale down annual salary increments, citing subpar performance in 2013.

2.4 Empirical Review

This refers to studies done by other scholars from economics, finance, accounting and management who have contributed immensely to financial performance and executive compensation literature both internationally and locally.

2.4.1 International Evidence

According to Jensen & Meckling (1976), Jensen (1986), Bebchuk & Fried (2004) reported that other salient components of executive compensation like perks, pensions and severance pay may involve colossal and huge amounts as a result of insufficient disclosure. From a sample of 478 large US companies from 1980 to 1984, the authors obtained similar results as the rest of the empirical literature regarding the sensitivity of pay (salary & bonus) to performance of 0.2 but conclude that the driving force behind this relationship is stock and stock options. When they include stock and stock options then the mean elasticity jumped to 4.5.

Murphy (1985), Coughlin & Schmidt (1985) and Barro & Barro (1990) from their numerous studies found pay performance elasticity in the range of 0.1 to 0.7 which suggested a 10% increase in corporate performance leads to 1.7% increase in CEO compensation.

Baker et al. (1985) through using company sales as the yardstick of performance and analyzing the relationship with executive compensation found out that the elasticity of executive annual salary plus bonus with respect to sales is 0.2 to 0.25 and is generally uniform across firms, industries and time periods. While these findings may be consistent with value maximization of large firms which employ better qualified and paid CEOs, the managers may not be behaving in an optimal way

Lambert and Larcker (1987) studied the relationship between managers' cash compensation and firm performance. They found that the relative proportions of accounting-based and market-based compensation vary as the theory predicts. In

particular they found out that ROE was more highly related to cash compensation than return on shares and the above relationship was strengthened when net income was less noisy relative to return on shares because as a result net income better reflected manager's effort. The above relationship for growth firms tended to be lower because the reason being historical-cost-based net income tends particularly to lag behind the real economic performance of a growth firm. Consequentially, this study provides empirical evidence consistent with agency theory

Rosen (1990) conducted several independent empirical studies on CEO pay for performance and concluded that the evidence from these studies suggests that the effect of stock returns on log compensation is in the 0.10-0.15 range. He further summarized a variety of academic pay for firm size elasticity works for different time periods in the U.S. and the UK and found some variation in CEO pay for firm size elasticities, but concluded that the estimated elasticities for all companies are not significantly different from $\beta = 0.3$.

Jensen & Murphy (1990b) reported in their studies that between 1974 and 1980, median CEOs of 1300 companies listed in the Forbes survey experienced changes in wealth of \$3.25 for every \$1000 change in shareholder wealth however salary and bonus changed at 2.2 cents per \$1000 change in shareholder value. They also reported that there is little evidence that relative performance to other firms in the same industry acted as a yardstick to managerial incentives. In contrast, Gibbons & Murphy (1990) established that both industry and market relative performance played an important role in shaping executive

pay. Market performance had a stronger effect than the relative industry performance using a large industry performance using a sample of 9425 firms in the period 1974 to 1984

Barro & Barro (1990) examined the pay performance relationship of large US banks over the period 1982-1987 and concluded that for the large banks CEO compensation is highly sensitive to performance.

Geihart & Milkovich (1990) analyze the pay of 14000 middle levels to top level managers in 1980 to 1985 dividing it to short term bonus, long term incentives and basic salary and found out that future ROA is positively related to the level of incentive pay but not base salary. Over the same period, Leonard (1990) found out that the presence of long term incentives plans associated with greater increases in ROE than those forms without long term incentive plans

Abowd (1990) analyses pay to performance sensitivity in firms' performance in a sample of 16000 managers in 250 large corporations from 1981-1986. He measured performance using operating income after taxes divided by replacement cost of assets and concluded a positive relationship to pay performance sensitivity

Lewellen, Loderer, Martin & Blum (1990) also studied the relationship between a level of compensation and firm's economic performance. Using a sample of 49 fortune 500 firms between 1964 and 1973, they found out that total compensation of a firms three

highest paid officers is positively related to differences in both common stock returns and operating profitability

The empirical literature on tournament models is quite small. Most of the studies have focused on the convexity of the pay structure. O'Reilly et al. (1988), Leonard (1990) and Main et al. (1993) all using the same data set have shown that differences in compensation between hierarchical levels are consistent with tournament theory. Similar results are obtained by Lambert et al. (1993) and in two detailed studies of the personnel records of a single firm, Lazear (1992) and Baker et al. (1994). In a recent study, Conyon (1995) using a large sample of UK firms also isolates a convex pay and job level relationship.

Aggarwal (1990) reported that the level of firm risk (firm return variance) is an important determinant of the level of remuneration and that is robust across other measures of firm risk. Failure to allow for a firm risk will under estimate the true performance relationship. Main et al. (1993) also considers the effects of the pay structure on the firm performance finding evidence in support of tournaments. They examined the effects of pay spread on the co-operative behavior of employees in a multi-task setting. They find strong evidence of a tournament structure; strong promotion incentives were associated with reduced helping efforts and increased individual efforts.

Gregg, Machin & Szymanski (1993) focus on the relationship between a highest paid director and firm performance with the UK data on sample of 288 large listed firms over

the period 1983-1991. They find evidence that the relationship between top director pay and firm performance is very weak in terms of share returns over the whole period.

However, after splitting the data into two sub-periods, i.e. 1983-1988 and 1989-1991 (recession period), they find a positive but small pay-for-performance relationship for the first sub-period, but not for the second. They also argue that growth in a top director's pay is strongly correlated with the growth of firm size: a 50% increase in a firm's sales leads to a 10% increase in a top director's compensation.

Main et al. (1996) & Conyon (1997) calculated annual returns by the log of the change in the return index over the whole year. Murphy (1999) pay performance relationship is in log form so that the pay performance estimate are interpreted as elasticities

Main, Bruce & Buck (1996) used the UK panel data for 60 firms from 1981 to 1989. They find evidence that due to executives' stock options there is a statistically significant relationship between a highest paid executive and firm performance. For example, a 10% increase in shareholder wealth increases top paid director's compensation about 9%. The key finding, however, is a greater sensitivity of top executive compensation on firm performance than the previous UK studies have suggested due to accounting for information on stock options in empirical analysis.

Hall & Liebman (1998) with the data from 1980 to 1994 using 15-year panel data on the large U.S. firms found out that CEO compensation is highly responsive to firm performance where stock and option holdings are accounted for in empirical analysis.

They arrived at elasticity of CEO compensation with respect to firm value of 3.9 for 1994 being about 30 times larger than the previous elasticity estimates. Thus, Hall & Liebman empirical evidence contradicts with previous studies, if the value changes of CEO stock and option holdings are accounted for in estimations and suggested that previous sensitivity measures ignored changes in the value of stock and stock options which account for virtually all the sensitivity.

However in a rejoinder to Hall & Liebman, Murphy (1998) finds that most of this increase is attributable to macro economic factors like a general rise in the stock market and that evidence is scarce suggesting that higher pay performance sensitivities lead to higher stock performance. Berkemu & Mejia (1998) market forces play a major role in determining pay of CEO, ownership structure of the firm and presence of competent and independent remuneration committees Efficient remuneration contracts should link the levels of executive compensation to aspects of performance over which managers have control and hence avoid rewarding or penalizing managers for both positive and negative factors respectively beyond their control however all these should be pegged against careful analysis of other benchmarks like the competitors and the general industry performance.

Tosi et al. (2000) reported that there is a weak correlation between CEO pay and performance but a strong positive correlation with CEO pay and size of the firm and it is this correlation which is turned into a causal mechanism, to reward managers for increasing the firm size of firms even though they destroy value in doing so.

Core et al. (2003) found out that the incentive effects of existing equity holdings often swallow those created in the current year compensation and they must be considered in analyzing the pay to performance sensitivity.

Shah et al. (2006) studied a sample of 114 listed companies in Pakistani for the period 2002-2006 and found out that CEO compensation is a function of performance measures, size, corporate governance variables like CEO duality, board independence and board size, ownership structures and concentration, audit committee independence. He found a positive relationship ($t=8.54$, 1% significant level) between total compensation and of the CEO and the size of the firm.

Ozkan (2007) through his study found out that there is a positive relationship between CEO pay and a firm's performance(at least in the UK) and the relationship is positive for cash compensation(salary and bonus) but when total compensation(cash compensation and equity compensation) is considered then the relation becomes less significant. Also he found out that there is a strong negative relation between CEO compensation and firm performance and further asserted that CEO and Board members engage in cronyism

Frydman & Saks (2008) through their studies found out that the average CEO compensation in large US public companies has increased in real terms by 500%. Equity compensation which until the 1980s has been insignificant accounts for almost all the growth.

Bizjak, Lemmon & Naveen (2008), Faulkender & Yang (2009) reported that firms benchmark their pay on peer groups to determine levels of executive salary , bonus or option rewards based on the industry and size. Size of the firm is the most important determinant according to Murphy (1999), also through his study he found out a strong relation between CEO cash compensation and firm's revenues for each 5 years period between 1970 and 1996 and is the same across industries.

Main et al. (1996), Buck et al. (2003), Ozkan (2010) established that the inclusion of equity incentive payments increases pay performance sensitivities. Conyon & Murphy (2000) documented that in 1997 fiscal year, UK CEOs total compensation was made up of base salary and pension 64%, equity based incentives 19%, and bonus 17% and that the use of equity based incentive was less prevalent on the financial services sector than other industries.

Fernandes et al. (2010) has undertaken an international comparison of CEO pay and reported that in the UK as a percentage of 2006 total compensation package salary and pension was 51%, equity based incentives was 30%, bonus 19% suggesting that there has been a decline in the importance of base salary and an increase in the percentage of equity based incentives pay for executives. Executive pay performance sensitivity with respect to cash compensation including base salary and non equity bonuses and their growth is well above inflation and wage growth for UK directors. It is the non equity incentive payments which were paid on the basis of past short term profits that have been

most heavily criticized by regulators (Walker 2009a, 2009b; FSA 2009) as not being related to long term performance. Previous UK studies that have explored relative performance evaluation found insignificant results (Main et al.1996; Benit & Conyon, 1999).

Tariq (2010) studied the 30 largest companies in Sweden from 2004 to 2008 and after controlling for firm size and growth opportunities found out a negative and insignificant relationship between pay and performance. The compensation of the CEO is an increasing function of size of the firm and also growth of the company.

2.4.2 Local Evidence

Most of the local studies on the subject of executive compensation and financial performance studied the effect of corporate governance on how executives are remunerated and its impact on performance.

Ogoye (2002) carried out an empirical study on the 41 public companies in Kenya between 1994 -1998 and established that salary, allowances, pensions and loans accounted for 70%, 14%, 7% and 6% of management compensation respectively. He also found that the relationship between management compensation and firm performance was negative and statistically insignificant. Sales were found to be positively and significantly related to management compensation.

Muriithi (2004) found no significant relationship between corporate governance and firm performance. He studied 44 companies quoted on the Nairobi Stock Exchange in the

period between 1999 and 2003 and came to a conclusion that no measure of firm performance has a significant relationship with the incentives of executive board members.

Mululu (2005) did a study on the relationship between board activity and firm performance of the listed firms at the NSE and indicated that governance structures are subject to more influence from the CEO and are correlated with higher levels of CEO compensation. Moreover, the boards' activity is positively related to the financial performance of firms suggesting that boards' activity is a value relevant to attribute in corporate governance. The CEO is able to determine his/her benefits through interference with the appointment of non executive directors and also members of the remuneration committee.

2.5 Summary of Literature Review

There still exists no consensus on what is the relationship between executive compensation and financial performance and what aspects of corporate performance have an effect on executive compensation. This has come to include a whole continuum of factors like performance, size, quality and experience of the CEO etc. Different studies conducted all over the world have yielded mixed and conflicting results either randomly or through methodology and timing differences both in Kenya, Europe and the U.S.

The effect of other firm specific factors like board size and CEO quality have continued to gain ground in explaining pay performance sensitivities (Bebchuk & Fried, 2004)

There have been varied and conflicting results found from different empirical studies carried all over the world.

Ogoye (2002) found out that the relationship between management compensation and firm performance was negative and statistically insignificant. Sales were found to be positively and significantly related to management compensation. Musyoka (2009) established an inverse and insignificant relationship between executive pay and financial performance among large banks in Kenya and further concluded that these results have negated the role of financial performance in determining executive compensation. Tariq (2010) studied the 30 largest companies in Sweden from 2004 to 2008 and after controlling for firm size and growth opportunities found out a negative and insignificant relationship between pay and performance.

To the contrary, other scholars have found positive relationships from their studies. Shah et al. (2006) studied a sample of 114 listed companies in Pakistani for the period 2002-2006 and found out that CEO compensation is a function of performance measures, size, corporate governance variables like CEO duality, board independence and board size, ownership structures and concentration, audit committee independence. He found a positive a relationship between total compensation and of the CEO and the size of the firm. Ozkan (2007) through his study found out that there is a positive relationship between CEO pay and a firm's performance(at least in the UK) and the relationship is positive for cash compensation(salary and bonus) but when total compensation(cash compensation and equity compensation) is considered then the relation becomes less

significant. Also he found out that there is a strong negative relation between CEO compensation and firm performance and further asserted that CEO and Board members engage in cronyism

In line of these conflicting results, there still exist a knowledge gap in the area of executive compensation and financial performance which future studies should address and which the findings of these study will also help to address. Most studies have established positive pay performance relationships though the executive compensation is increasing at a higher rate than financial performance which has been seen as immoral by ethical proponents.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter covers the overall research design and this includes research design, targeted population, sample procedures, data collection methods, procedures of data collection and analysis. The study was carried out with the intention of establishing the relationship between financial performance and executive compensation of the commercial banks in Kenya.

3.2 Research Design

The research design used in this study is a descriptive cross sectional design. This is a study in which data is gathered systematically over a period of time in order to answer a research question. This descriptive cross sectional design was applied in this study because there is need to establish any causal relationship between executive compensation and financial performance.

3.3 Target Population

The target population comprised of all the commercial banks in Kenya. The population of the study was all the 43 commercial banks in Kenya as at the end of December 2013 as listed in appendix 1.

3.4 Sampling

The sample size consisted of seventeen banks for which executive remuneration data was available for the five-year period. Of this sample 10 banks were listed – Barclays Bank, CFC Stanbic Bank, Co-operative Bank, Diamond Trust Bank, Equity Bank, I &M bank, Kenya Commercial Bank, National Bank of Kenya, NIC Bank, Standard Chartered Bank. The other remaining banks were not listed and they included Family Bank, Transnational, Imperial, Consolidated bank, Victoria Commercial bank, Bank of Africa and Prime bank. This sample list is contained in appendix 2.

3.5 Data Collection

Data collection refers to the gathering of information to serve or prove some facts. It aims at proving or refining some facts and in arriving at logical conclusions. The study used secondary data obtained from the audited financial statements prepared as per the Companies Act provisions and downloadable from the respective websites. The population parameters were the levels of executive compensation, total customer deposits, returns on equity and board size for the sampled seventeen commercial banks for five years ending December 2013.

3.6 Data Analysis

The data collected was examined before analysis commences for completeness and consistency. The data was entered into SPSS for analysis as a time series data. The study

applied a multiple regression model on the accounting based measures of performance used in this study namely ROE, customer deposits, board size against levels of executive compensation. The variables were described as dependent variables and independent variables. In analyzing the effect of the compensation structure on firm performance, following Mehran (1995), only realized compensation was considered rather than compensation due for both practicability and objectivity given the sensitivity of data and the limited mandatory disclosures of executive compensation for banks in Kenya.

Analysis was performed using directors' emoluments/remuneration/fees as a proxy for executive compensation since the bulk of the executive compensation is actually the realized directors' remuneration. Because most of the existing literature investigating the executive pay-performance relationship uses a model to relate pay and performance, the study also considered functional form relationship between the financial performance measures and the level of executive compensation.

3.6.1 Analytical Model

The research used a regression analysis to test the relationship between executive compensation and an aspect of financial performance like ROE etc over the given time interval of 5 years. Due to the fact that the existing literature on executive pay-performance relationship uses a model to relate pay and performance (Pay - performance sensitivity model of Jensen & Murphy, 1990 and pay - performance elasticity model of Hall & Liebman, 1998), the study too considered functional form relationship between the level of executive remuneration and financial performance. Ideally the relationship between executive compensation and financial performance should be positive but

different studies have yielded conflicting results.

$$\ln(\text{Total Compensation}) = \alpha + \beta_1(\text{Performance}) + \epsilon' \dots \dots \dots (1)$$

Where α is the intercept.

β_1 is the coefficient of performance.

$\ln(\text{Total compensation})$ is the logarithmic series of executive compensation which included total director remuneration, bonus and fees in the 5 year period as dependent variable. The logarithmic specification has the advantage of being less sensitive to outliers (Cuñat & Guadalupe 2004).

$$\ln(\text{Total Compensation}) = \alpha + \beta_1(\text{Performance}) + \beta_2(\text{Firm Size}) + \beta_3(\text{Board size}) + \epsilon'$$

Where:

Total compensation = Total director remuneration, bonus and fees

Size is depicted by the natural log of the banks' total customer

Size = deposits

Performance = Performance is measured by the return on equity (ROE)

Coefficients β_1 , β_2 , and β_3 were used to measure the sensitivity of the dependent variable to unit changes in the three explanatory variables.

3.6.2 Test of significance

Once the data has been gathered through secondary means of data collection, statistical inference allows analysts to assess evidence in favor of some claim about the population parameters under analysis. R^2 was used in the prediction of future outcomes or the testing of hypotheses on the basis of other related information. It provides a measure of how well observed outcomes are replicated by the model and also the proportion of total variation of outcomes is explained by the model. Other statistical inference tools used are collinearity diagnostics, correlation, regression analysis and ANOVA.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the results of the study in terms of descriptive analysis and inferential analysis. The chapter also presents a discussion of the findings.

4.2 Descriptive Analysis

Table 4.1 shows the summary descriptive results in terms of number of observations (N), mean, and standard deviation of both the dependent and independent variables

Table 4.1: Summary Descriptive Results

	N	Mean	Std. Deviation
Director remuneration	17	103,627.21	100,550.08
Customer deposits	17	66,491.66	55,692.22
Size of board	17	10.29	3.48
Performance	17	25.13	8.43

Source: Research Findings

The results in Table 4.1 show that performance, measured as ROE, had a mean of 25.13 with a standard deviation of 8.43. The mean director remuneration was Sh. 103,627,000 with a standard deviation of Sh. 100,550,000. The customer deposits averaged Sh. 66,491 million with a standard deviation of Sh. 55,692 million. The size of the board averaged 10.29 members with a standard deviation of 3.48 members. A total of 17 observations were made.

4.3 Collinearity Diagnostics

Table 4.2 shows the correlation analysis results on all the variables under study. A keen interest will be the interrelationships between the independent variables.

Table 4.2: Correlation Matrix

	1	2	3	4
Director remuneration	1			
Customer deposits	.456	1		
Performance	.366	.542*	1	
Size of board	.547*	.642**	.166	1

Source: Research Findings

The results in Table 4.2 show that none of the correlations among the independent variables were high enough to conclude that the independent variables were serially correlated. Size of the board could however seem problematic in the model given the slightly higher correlations with both performance and customer deposits. This called for a more rigorous method to test this further and thus a VIF test is conducted.

Table 4.3 also shows the level of collinearity among the independent variables. This is done through the VIF tests.

Table 4.2: Collinearity Statistics

	Tolerance	VIF
Customer deposits	.393	2.545
Performance	.651	1.537
Size of board	.541	1.850

Source: Research Findings

VIF (Variance Inflation Factors) measures how much the variance of the estimated coefficients is increased over the case of no correlation among the X variables. If no two X variables are correlated, then all the VIFs will be 1.

If VIF for one of the variables is around or greater than 5, there is collinearity associated

with that variable and hence one of these variables must be removed from the regression model. The results in Table 4.3 show that all the independent variables scored VIF values of less than 5 and no two of them had VIF values of close to or above 5. This suggests that the level of collinearity among the independent variables was very low hence all the variables can be incorporated into the subsequent regression analysis.

4.4 Regression Analysis

Table 4.4 shows the results of the model summary in terms of R, R^2 , adjusted R^2 and the Durbin Watson.

Table 4.3: Model Summary

R	R^2	Adjusted R^2	Std. Error of the Estimate	Durbin-Watson
.742	.550	.446	.59559	2.299

Source: Research Findings

The results in Table 4.4 show that the model had a high impact on determining the performance of banks ($R = 0.742$). The R^2 value shows that the model accounted for 55% of the variance in director remuneration while the adjusted R^2 shows that the model accounted for 44.6% of the variance in performance. The Durbin-Watson statistic shows that there was no autocorrelation in the data.

The ANOVA results are shown in Table 4.5. The results show the F-statistic and its significance in order to evaluate whether the model was fit to test the relationship between director remuneration and bank performance.

Table 4.4: ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	5.639	3	1.880	5.299	.013
Residual	4.611	13	.355		
Total	10.250	16			

Source: Research Findings

The results in Table 4.5 show that the F-statistic was significant at 5% which suggests that the model was fit to explain the relationship between bank performance and director remuneration, given a 5% chance of error.

Table 4.6 shows the regression coefficient results of the study for each of the independent variables and how they influence director remuneration.

Table 4.5: Regression Results

	Unstandardized		Standardized	t	Sig.
	Coefficients		Coefficients		
	B	Std. Error	Beta		
(Constant)	9.061	.737		12.293	.000
Deposits	0.000001083	.000	.075	.254	.803
Performance	.037	.022	.392	1.699	.113
Size of BOD	.114	.058	.496	1.961	.072

Source: Research Findings

The results in Table 4.6 show that director remuneration had a positive relationship with bank's financial performance. This relationship was however insignificant at 5% level.

The results also show that customer deposits (size of the bank) had a positive relationship with director remuneration. This relationship was insignificant at 5% level.

The results also show a positive relationship between size of the board and the director remuneration. This relationship was significant at 10% level

4.5 Interpretation of the Findings

The study sought to determine the relationship between banks' financial performance and director remuneration. The results showed that bank financial performance as measured by ROE had a positive relationship with director remuneration. This relationship was however insignificant at 5% level

This is contrary to findings by Musyoka (2009) and Ozkan (2007) and therefore implies that the financial performance of a bank does not influence the director remuneration to a greater extent and hence there is need to determine other factors which influence director remuneration for commercial banks in Kenya e.g. risk, size of the bank, skill, quality and experience of the executives.

The study also assessed the effect of customer deposits on the director remuneration in banks in Kenya. The results showed that customer deposits had a positive relationship with director remuneration. This relationship was insignificant at 5% level. This suggests that customer deposits which are a measure of bank size do not influence director remuneration of commercial banks in Kenya. This is contrary to findings by Musyoka (2008), Jensen & Murphy (1990), Conyon & Murphy (2000) and Rosen (1990) who found out pay-for-firm size elasticity to be positive and the estimated elasticities were not significantly different from 0.3 i.e. $\beta = 0.3$. In this study overall sensitivity of executive

compensation to bank size was 0.000001083. This may suggest that CEO pay of banks and especially smaller banks is determined by other qualitative factors like CEO quality, age, skills and this could agree with findings by Banghoj et.al. (2008).

The study further examined the effect of the size of the board on director remuneration for commercial banks in Kenya. The results showed a positive relationship between size of the board and the director remuneration. This relationship was significant at 10% level and according to Ozkan (2007) he asserted this because the CEO and board members engage in cronyism leading to higher levels of executive compensation. The results mean that the director remuneration in commercial banks in Kenya is influenced by the size of the boards and hence the larger the BODs then the higher the levels of director remuneration. There is need to ensure that we have lean and efficient BODs who are able to carry our oversight and steer the company towards achieving its objectives. On average the size of the board is 10.29 with an average compensation of kshs.103, 627,000

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of findings, conclusions, recommendations, limitations of the study, and suggestions for further research.

5.2 Summary

The study sought to determine the effect of financial performance on executive compensation of commercial banks in Kenya. Secondary data was collected on 17 selected commercial banks for the period 2009 – 2013. The data on ROE, size of the board, director remuneration, and customer deposits was sourced from the respective commercial banks audited accounts and the Central Bank's bank Supervision Department yearly reports

The study found that ROE had a mean of 25.13 with a standard deviation of 8.43. The mean director remuneration was Sh. 103,627,000, customer deposits averaged Sh. 66,491 million with a standard deviation of Sh. 55,692 million, and size of the board averaged 10.29 members.

The study found that the model had a high impact on performance of banks ($R = 0.742$) and it accounted for 55% of the variance in bank performance. The F-statistic was significant at 5% which suggests that the model was fit to explain the relationship between bank performance and director remuneration. The coefficient results revealed that bank performance had a positive but insignificant relationship with director remuneration. The results also showed that customer deposits had a positive but

insignificant relationship with director remuneration. The results further show a positive and significant relationship between size of the board and director remuneration.

5.3 Conclusion

The study determined the effect of financial performance on executive compensation of commercial banks in Kenya. The results showed that financial performance as measured by ROE had a positive but insignificant relationship with director remuneration for commercial banks in Kenya. The study therefore concludes that a bank's performance does not affect director remuneration of commercial banks in Kenya.

The study also assessed the effect of customer deposits on the director remuneration of banks in Kenya. The results showed that customer deposits had a positive but insignificant effect on director remuneration. The study therefore concludes that customer deposits do not affect the director remuneration of commercial banks in Kenya.

The study further examined the effect of size of the board on director remuneration of commercial banks in Kenya. The results showed a positive and significant relationship between size of the board and director remuneration. Thus, the study concludes that the size of the board affects the director remuneration of banks in Kenya.

5.4 Recommendations for Policy

The study recommends that since director remuneration is not influenced by the performance of a firm but by other factors, it may be important for banks to peg the

director pay on the performance of the firm in order for the payments not to hurt bank performance. As it seems, the more the number of board members, the higher the pay. The study also recommends that policy makers should control the director remuneration as higher levels do not necessarily improve the financial performance of a commercial bank. There is need to sensitize executives among the Kenyan banking fraternity on the need to align their payment to accounting performance measures as these measures are directly linked to the maximization of shareholder wealth.

The study also recommends that to control the director remuneration, banks should have smaller boards as larger boards may lead to higher board compensations. This way, a lean and efficient board may help improve firm performance as the profit after tax will be increased and this will increase the ROE.

5.5 Limitations of the Study

The study focused on only 17 commercial banks. Thus, the results of the 17 banks may not be representative of all the commercial banks in Kenya. This may limit the applicability of the findings to all commercial banks in Kenya.

The study found limitations in the availability of data and relaxed disclosure requirements which do not mandate specific disclosures of executive compensation like the different components of CEO pay and the breakdown of remuneration per director rather than the total director remuneration which is being provided now.

The model used accounts for about 55% of the variance in director remuneration. Thus, almost half of the variance in director remuneration was as a result of other factors not examined in the study. Therefore, this limits the robustness of the model in explaining director remuneration.

5.6 Suggestions for Further Research

There is need for more studies in this area to determine how bank's financial performance influence director remuneration. This can be done by including all banks in Kenya and by conducting a panel regression analysis.

There is need for more studies in this area to determine other factors apart from financial performance, size of the bank and size of the BODs which influence the levels of director remuneration for banks in Kenya.

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Appendix I: List of Commercial Banks in Kenya as at 31/12/2013

1. African Banking Corporation Limited
2. Bank of Africa Kenya Ltd
3. Bank of Baroda (K) Ltd.
4. Bank of India
5. Barclays Bank of Kenya Ltd
6. CFC Stanbic Bank Ltd
7. Charterhouse Bank
8. Chase Bank Ltd
9. Citibank N.A. Kenya
10. Co-operative Bank of Kenya Ltd
11. Commercial Bank of Africa Ltd
12. Consolidated Bank of Kenya
13. Credit Bank
14. Development Bank of Kenya
15. Diamond Trust Bank Ltd
16. Dubai Bank Kenya Ltd
17. Eco Bank Ltd
18. Equatorial Commercial Bank Ltd
19. Equity Bank
20. Family Bank Ltd
21. First Community Bank Ltd
22. Fidelity Commercial Bank Ltd
23. Giro Commercial Bank Ltd
24. Guaranty Trust Bank Ltd formerly Fina Bank
25. Guardian Bank Ltd
26. Gulf African Bank Ltd
27. Habib Bank A.G. Zurich
28. Habib Bank Ltd
29. Imperial Bank Ltd
30. Investments & Mortgages Bank Ltd
31. Jamii Bora Bank Ltd
32. K-Rep Bank Ltd
33. Kenya Commercial Bank Limited
34. Middle East Bank (K) Ltd
35. National Bank of Kenya Ltd
36. NIC Bank Ltd
37. Oriental Commercial Bank Ltd
38. Paramount Universal Bank Ltd
39. Prime Bank Ltd
40. Standard Chartered Bank (K) Ltd
41. Transnational Bank Ltd
42. UBA Kenya Ltd
43. Victoria Commercial Bank Ltd

(Source: Central Bank Bank Supervision Department Report – 2013)

Appendix II: List of the sampled Commercial Banks in Kenya

1. Bank of Africa Kenya Ltd
2. Barclays Bank of Kenya Ltd
3. CFC Stanbic Bank Ltd
4. Co-operative Bank of Kenya Ltd
5. Consolidated Bank of Kenya
6. Diamond Trust Bank Ltd
7. Equity Bank
8. Family Bank Ltd
9. Imperial Bank Ltd
10. Investments & Mortgages Bank Ltd
11. Kenya Commercial Bank Limited
12. National Bank of Kenya Ltd
13. NIC Bank Ltd
14. Prime Bank Ltd
15. Standard Chartered Bank (K) Ltd
16. Transnational Bank Ltd
17. Victoria Commercial Bank Ltd

Appendix III: Average data for 2009 to 2013

	BANK	Director Remuneration	Customer Deposits	ROE	Size of board
1	KCB	143,818.60	194,407.40	27.56	11.60
2	EQUITY	461,600.00	117,066.80	31.57	16.00
3	CO-OP BANK	96,231.40	139,066.60	27.25	18.80
4	STANCHART	117,077.60	120,969.20	36.61	10.20
5	BARCLAYS	115,400.00	132,587.80	36.44	10.40
6	CFC STANBIC	65,882.40	74,782.40	24.11	11.40
7	DTB	64,814.20	59,626.00	29.35	11.00
8	NBK	85,083.40	55,942.40	19.15	11.80
9	I&M	32,207.80	55,573.20	25.97	9.40
10	NIC	139,029.60	61,201.00	27.88	10.60
11	FAMILY	107,189.60	20,934.40	18.32	11.00
12	PRIME BANK	52,484.40	30,168.80	24.36	5.00
13	TRANSNATIONAL	16,490.40	4,770.20	12.29	6.60
14	IMPERIAL	103,744.40	21,367.80	39.05	7.00
15	CONSOLIDATED	30,405.00	9,987.20	10.93	9.80
16	VICTORIA	23,563.00	6,304.00	23.60	5.00
17	BOA	106,640.80	25,603.00	12.79	9.40

Source: Research Findings