

**THE RELATIONSHIP BETWEEN EXECUTIVE COMPENSATION
AND RISK AMONG COMMERCIAL BANKS IN KENYA**

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DECLARATION

This research project is my original work and has not been presented for examination in any other University.

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This research project has been forwarded for examination with my approval as the University supervisor.

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DEDICATION

My dedication for this research project goes to my family both immediate and extended for their unrelenting support and their encouragement throughout my study at the University of Nairobi.

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ABSTRACT

In the Kenyan environment, the executive compensation has not come under massive spotlight perhaps due to the nature of CEO compensation. 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. A major criticism of executive pay packages has been that they incentivize excessive risk taking which contribute to the financial turmoil. Many studies when attempting to find causal relationships between CEO pay and risk taking find mixed evidence. This level and type of mixed results on the link between executive compensation and risk taking provides a strong basis for this Kenyan specific study. This study takes a departure from such past Kenyan based studies by incorporating assessing how risk taking is related to executive compensation.

This study used descriptive survey research design. The population of this study was all forty three commercial banks and one mortgage institution licensed by the Central Bank of Kenya as at 31st December 2011. This study used both stratified sampling and simple random sampling. Stratified random sampling was used in each bank to group respondents into three strata. The strata were those of executive management, senior management and middle management. Within each of the three strata simple random sampling was done. Data on executive remuneration was the average of four years (2008-2011) while primary data on the dependent variables was collected through the questionnaire from July 2012 and concluded in August 2012. Data was analysed using statistical package for the social sciences (SPSS).

The study found that executive compensation has insignificant relationship with risk taking among commercial banks in Kenya. Risk taking was measured by use of non-performing loans, money laundering, creative accounting and dividend pay-out. A further study to establish the determinants of executive compensation among commercial banks in Kenya is therefore recommended. The management of commercial banks should continue to enhance controls within operational areas that can pose a risk to the bank. Management actions should continue to be reviewed to ensure that they do not affect the banks business adversely.

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ABBREVIATIONS & ACRONYMS

AIG	American International Group
CBK	Central Bank of Kenya
CEO	Chief Executive Officer
GAAP	Generally Accepted Accounting Principles
OCC	Comptroller of the Currency
OTS	Office of Thrift Supervision
NSE	Nairobi Securities Exchange
NPL	Non Performing Loans
ROA	Return On Assets
ROE	Return On Equity
SEC	Securities and Exchange Commission
TARP	Troubled Asset Relief Program

CHAPTER ONE : INTRODUCTION

1.1 Background

According to Forbes (2012), executive Compensation is the term used to refer to the wage and benefit packages that comprise the pay received by top executives of business corporations. Executive Compensation may also include options and other incentives based upon the company's earnings. It is the role of the chief executive (CEO) and other executives to oversee the company's strategy and operations. Obviously, these individuals require compensation for their work. It is the responsibility of the compensation (or remuneration) committee of the board of directors to design executive compensation contracts. The "right" amount to pay an executive is the minimum amount it takes to attract and retain a qualified individual. Executive compensation packages generally include a mix of short-term incentives (including salary, annual bonus, benefits, and perquisites) and long-term incentives (including stock options and restricted shares).

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).

Compensation crisis and risk especially in the financial industry can result from people who are rewarded with large bonuses for gaming the system, creating artificial value, obfuscating, and taking on excessive levels of risk, all without sufficient skepticism or scrutiny (Burnison, 2009). This statement naturally raises the question if there is any evidence supporting that compensation practices in the financial sector induce excessive risk taking behavior. For

example in the US, for a variety of reasons (such as protecting small savers and eliminating destabilizing bank runs), governments guarantee bank deposits up to a particular dollar threshold. In the absence of deposit insurance, creditors would be more inclined to force banks to hold significantly higher levels of capital and engage in activities with reasonable amounts of risks. With deposit insurance, managers at insured financial institutions are less concerned about bank runs, and they may also have more opportunities to take excessive or imprudent risks since creditors are less incentivized to monitor them. The premiums paid by banks for deposit insurance are meant to counteract the problems that were introduced by the provision of government deposit guarantees, as are mandatory supervision and regulation of bank activities by government agencies—but these countermeasures may be only a partial antidote.

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).

The compensation package may also include guarantees such as a severance agreement, change in control provision (if the company is bought out), and pension. An efficient compensation plan involves a delicate mix of incentives, risks, and decision horizon considerations (Scott, 2006). So the well designed compensation contract plays a key role in alleviating the conflict between agents and principals. Gao and Shrieves (2002) argue that the components of executive compensation influence earnings management. Any changes in the design of compensation contracts will potentially lead to a change in managers' actions.

Compensation programs should link variable portions of total compensation to the economic objectives of the corporation. To ensure this is the case, boards should fully understand the effects of all components of a pay package to appropriately balance base pay and other components and avoid distortion of variable components by managers acting

opportunistically. Performance should be measured over sufficiently long assessment periods to determine if decisions were successful in creating sustainable shareholder value. Boards should consider a diversified set of financial and extra-financial performance metrics and targets. Performance metrics should be used during annual performance evaluations and metrics that can be easily manipulated should be avoided. Boards should discuss disclosing performance targets to shareholders, weighing the benefits of increased transparency against any potential loss of competitive advantage. Boards should consider what compensation methods can be used to avoid the distortions and pitfalls of some equity-based incentive programs. (Matteo,2008).

Many observers like Matteo (2008), Mululu (2005), Subhajit (2010) and Burnison (2009) believe that top-level executive compensation is not sufficiently linked to long-term corporate performance. There are several cases in which executive pay at companies rose dramatically even though the companies were doing poorly and the stock prices were plummeting. Overly generous compensation packages with large-sized stock option grants may have created incentives for managers to manipulate company financial statements in order to drive up stock prices, contributing to the corporate scandals of the post-dotcom era and the current financial crisis. Besides the insufficient link between compensation and stock prices, the level of executive compensation is also widely believed to be much higher than that required to retain and motivate effective top managers (Michael, Dalida, Prabhala and Lemma, 2011).

There has been a debate on executive compensation among regulators, practitioners, and academicians. Some studies like Matteo (2008) and Taylor (2009) find no evidence that compensation affected financial firms' performance during the globacrisis. Others like 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).

Bhattacharyya and Morrill (2008) performed Tobit analysis in relation to managerial compensation and dividend payout in the US firms over the period 1992-2001 so as to document empirical support for hypothesis arising from his model developed in 2007. Consistent with the prediction of the Bhattacharyya's model, a positive (negative) relationship between earning retention ratio (dividend payout ratio) and managerial compensation was found.

1.1.1 Commercial Banks in Kenya

During the quarter ended September 30, 2011, the commercial banking sector comprised 43 commercial banks, 1 mortgage finance company, 6 deposit taking microfinance institutions, 3 representative offices of foreign banks, 121 foreign exchange bureaus and 2 credit reference bureaus. The Kenyan Banking Sector registered enhanced performance with the size of assets standing at Ksh. 2.0 trillion, loans & advances worth Ksh. 1.2 trillion, while deposit base was Ksh 1.5 trillion and profit before tax of Ksh. 63.5 billion as at 30th September 2011. Over the same period, the number of bank customer deposit accounts stood at 13.65 million with a branch network of 1,114 (CBK, 2011).

In the Kenyan environment, the executive compensation 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, Hancock, and Izan, 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 banking industry 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 banks 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 as stated in the (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 (Yoram and Alon ,2010).

Many studies when attempting to find causal relationships between CEO pay and risk taking find mixed evidence (Spitz-Oener, 2006). Mueller (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 (2010) 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 Vallascas and Hagendor (2010) find an empirical support to this idea, showing that higher bonuses entail a lower default risk. This level and

type of mixed results on the link between executive compensation and risk taking provides a strong basis for this Kenyan specific study.

Studies done locally on executive compensation include Rimberia (2001) who conducted a survey on the use of flexible human resource practices by manufacturing firms in Nairobi. Aduda (2011) did a study the relationship between executive compensation and firm performance in the Kenyan banking sector. Roba (2008) did a survey to assess the extent of adoption of strategic human resource management practices at Teachers Service Commission of Kenya. Mululu (2005) did a study the relationship between board activity and firm performance of firms quoted on the Nairobi Stock Exchange. Muriithi (2004) who did the relationship between corporate governance mechanism and performance of firms quoted at the Nairobi Stock Exchange. The above Kenyan specific studies on executive compensation left some gaps in terms of study variables which have been taken up by this current study and informed the study gap. This study therefore takes a departure from such past Kenyan based studies by incorporating the assessment on how risk taking is related to executive compensation. The foregoing therefore makes it imperative to conduct a study to determine the extent to which executive compensation can contribute to risk taking among commercial banks in Kenya.

1.3 Research Objective

The main objective of this study was to establish the relationship between executive compensation and risk among commercial banks in Kenya.

1.4 Significance of the Study

This study is of importance and relevance to various stakeholders as explained hereunder.

Government can benefit from this study by incorporating the various policy recommendations and implications into policy making process. Through the findings and recommendations of this study the government is able to structure well targeted polices and regulation for executive compensation in order to create the desired economic outcomes and impacts.

The study will help banks in evaluating the importance of executive compensation and its effect on risks. Banks, especially commercial ones, are swiftly becoming more aware of the importance of executive compensation in this era and this study will add impetus to knowledge on the link between executive compensation and risk.

To the researchers and academicians, this study will add value to the existing body of knowledge. This study will also explore and suggest various research gaps which will trigger further research by scholars. The final research will be available as a one stop document for scholars interested in research in the area of executive compensation or related areas.

CHAPTER TWO : LITERATURE REVIEW

2.1 Introduction

This chapter reviews literature in the area of executive compensation. It starts by reviewing the theoretical literature advanced in the area of executive compensation. This chapter also looks at the empirical literature, the summary and research gap.

2.2 Theoretical Literature Review

According to Trochim (2006) Aguilar (2009), and Tormo (2006), a theoretical framework guides research, determining what variables to measure, and what statistical relationships to look for in the context of the problems under study. Thus, the theoretical literature helps the researcher see clearly the variables of the study; provides a general framework for data analysis; and helps in the selection of applicable research design. The Theory guides every aspect of research, from formulation of the research question through operationalization and discussion.

2.2.1 Principal Agent Theory

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 principal and the agent, are minimized.

2.2.2 Resource Dependence Theory

Pfeffer and Salancik (1978) determined three factors that influence the level that dependence organizations have on particular resources. First, the overall importance of the resource to the firm is critical in determining the resource dependence of the firm. Second, the scarcity of the resource is also a factor. The scarcer a resource is the more dependent the firm becomes. Finally, another factor influencing resource dependence is the competition between organizations for control of that resource. Together, all three of these factors act to influence the level of dependence that an organization has for a particular resource. Resource dependence theory also suggests that a firm's strategic options are determined to a great extent by the environment. Since firms are dependent on the environment for resources, they need to enact strategies that will allow them to acquire these resources. Therefore, the external environment has already been determined for these firms, and they experience little strategic choice. However, those who support the notion of managerial choice have argued that some organizations are more effective than others in the same environments, thus proving that strategic choice does exist.

The conflicts are related to sharing the economic resources and the lack of confidence, these conflicts between the shareholders and managers being considered in the literature to be the root of creative accounting. One of the scarce resources is good management and hence they are remunerated to keep them in a company in order to pursue shareholder interests. This kind of shareholders-management interaction is debated by Demski (1994), and further by Christensen and Feltham (2005).

2.2.3 Legitimacy Theory

Suchman (1995) adopted a broad definition of legitimacy, defining it as a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs and definitions. This particular definition of legitimacy asserts that a social contract exists between the entity and society. Maintaining legitimacy is an issue organisations are faced with constantly. Organisations need to provide assurances to society about their ongoing performance through warm signals such as speeches or long term contracts (Ashforth and Gibbs, 1990). This contributes to maintaining a social contract with society. Part of maintaining legitimacy is also to prevent or overcome challenges to legitimacy. A crisis management plan should be established and ready to be used should a crisis occur. Past accomplishments gained from

legitimacy also need to be protected and built upon (Suchman, 1995). Ultimately, no entity is able to completely satisfy society's expectations but maintaining legitimacy is about communicating with audiences and letting them know what is happening. There are several problems associated with legitimacy.

Ashforth and Gibbs (1990) termed it the double edge of legitimation and suggested that a low level of legitimacy should not be seen as a lack of legitimacy but rather a challenge that needs to be dealt with. When legitimacy is problematic, the entity faces criticism by society which may lead to less capacity of resources to defend legitimacy (Ashforth and Gibbs, 1990). In this case, the organization should attempt to repair its legitimacy by re-building up its credibility with its audience. A good example of a legitimacy problem in the US is to do with executive compensation in recent times. CEO salaries in US have reached high levels, creating legitimacy problems with the public, some of which whom believe that CEOs, through their hard work deserve high salaries while others believe that CEOs don't work hard and therefore don't deserve high salaries.

2.3 Empirical Literature Review

Aduda (2011) in his study on the relationship between executive compensation and firm performance in Kenyan banking industry finds a negative non-significant relationship between executive compensation and bank performance and further recommends that there is need to reign in the executive compensation tendencies in smaller banks to favor bigger shareholders who double up as bank directors to the detriment of returns and smaller owners of the bank. The study finds limitations in the availability of data and relaxed disclosure requirements which do not mandate specific disclosures of executive compensation. The negative correlation appears to suggest the capping of executive compensation to ensure maximization of returns to shareholders. As such, the interests of the executive directors are subordinated to those of the shareholders in keeping with the agency theory.

Aduda (2011) further asserts that a negative relationship between executive compensation and size is attributable to the diminishing influence of Key owners with directorships as the bank grows in size. Performance ratios and opportunity only appear to be inversely related to big banks as their executives appear to subordinate their immediate financial interests to that of the overall goal of the firm which is to maximize profitability. Consequently, there is need

to reign in the executive compensation tendencies in smaller banks to favor bigger shareholders who double up as bank directors to the detriment of returns and smaller owners of the bank. Further, 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.

Mehran and Rosenberg (2007) argue that stock options increase risk taking, but lower borrowing and raise capital ratios. Pathan (2009) analyzes data on 212 banking holding companies for the period of 1997 to 2004 (which includes the economic downturn of 2001), finding that banks with 'strong' boards increase risk taking; however, independent directors dampened this relationship, presumably because of broader concerns for other stakeholders such as bondholders. In an important study, Fahlenbach and Stulz (2009) pursue an analysis of the crisis of 2008, similar to our own, find no evidence that banks lead by CEOs whose incentives were closely aligned to shareholders via invested wealth performed better; they found some evidence that they performed worse. They found no relationship between performance and stock option incentives. Cheng, Hong, and Scheinkman's (2009) study shows that residual pay (once controlling for other predictors) is correlated with various risk measures. They found no effect of governance variables on risk taking.

John et al. (2000) make theoretical arguments highlighting the continuing viability and importance of an empirical investigation into the relation between executive compensation and risk. Coles et al. (2006), Low (2009), and others note that one possible explanation for the mixed empirical evidence on the relationship between stock options and firm risk is that because equity incentives and firm risk are endogenously related, the relationship is difficult to empirically identify. Kato and Kubo (2005) examine the link between CEO compensation and firm performance in Japan by utilising panel data on individual CEO's salary and bonus of Japanese firms from 1986 to 1995. They find that CEO's cash compensation is sensitive to firm performance, especially on accounting measures. However, stock market performance seems to be less important factor in the determination of CEO's compensation. One reason for an extremely modest link between CEO compensation and firm stock market performance in the period can be the fact that until 1997 executives' stock options were banned in Japan, except at small venture companies.

There is wide-spread agreement on the proximate causes of the current financial crisis: banks had substantial exposure to subprime risk on their balance sheets, and these risky assets were funded mostly by short-term market borrowing. Among the explanations for why banks exposed themselves to such risks, a prominent explanation that has been advanced by policymakers, bank supervisors and academics is that there was a failure of risk management at banks. One argument that focuses on agency problems within banks is that trader and other bank executives with high-powered pay-for-performance schemes were exploiting deficiencies in the internal control systems, and risk managers were unable or powerless to restrain them. Another argument is that bank managements were unaware of their risk exposures because they were assessing risks historically and were neglecting what appeared to be low probability, non-salient events that turned out to be significant (Shleifer, 2011).

Effective solutions on the NPL problem can boost the competitiveness of a banking system. Chinese NPLs have attracted a lot of attention in 1998, as a negative outcome of the reforms passed (Lin and Zhang 2009). As a response, the Chinese government set up four State-owned asset management corporations to handle bad debts and injected capital into the big four banks. However, according to Ernst & Young (2006) report on Global Nonperforming Loans it appears that the NPL problem will persist as China's growing property markets will produce new NPLs in the forthcoming years. Studies on bank failures found that the asset quality is a significant predictor of insolvency, and that the failing banks always have high levels of NPL. This especially applies to investment and development banks, as the NPLs are not always the main (operational) problems faced by commercial banks. In this light we include NPLs as an additional measure of performance in order to consider the potential risk usually in line with high profits and high executive compensation.

In addition Deshpande (2002) describes two kinds of "myopia" in executive behavioural analyses arising from non well-structured incentive contracts. The first one is termed "Passive Myopia", meaning that agents focus mainly on short-term activity management, paying little attention to long-term performance, which, undoubtedly, appears to be a common problem in most companies around the world. The second one is called "Active Myopia", created by stock-option based compensation, in which the agents "take long-term capital investment decisions with short-term signaling intentions", resulting in a long lasting adverse effort. Either of the above can causes a gap between pay and performance. Where the executive focus on short term performance they result in giving out loan to unqualified

individual as it happened in America where individuals were given compensation based on mortgage sold resulting to high non performing loan and eventually asset bubble.

Tosi, Werner, Katz & Gomez-Mejia (2000) mention that executives favor information asymmetry in their decision making process, as they prefer to pursue their own targets, which often do not coincide with shareholders'. Thus, exploring the way of aligning shareholders' interests with managers' compensation benefits becomes one of the main considerations in corporate governance. The purpose of a compensation contract is to reward executives in such a way that they strive to maximize firm performance, so that both executives and shareholders can meet their expectations. Designing a compensation package is not an easy task. Rewards can be classified as a) intrinsic; or b) extrinsic. Although the former cannot be controlled directly, they can be influenced through extrinsic rewards (e.g. monetary incentives, promotions, and praise). In particular, promotion might play a significant role in state-owned banks in China; in this case most of the executives are appointed by the state (the controller and biggest shareholder) rather than through open-market criteria. Therefore, the executives in China could be considered as public officers. The information asymmetry may be used by the executive to increase risk in the business due to high non performing loan where the executive fail to disclose loan information.

Taylor (2009) pointed out that the recent financial and liquidity crises had several "pressure points" that the boards of directors can address to ensure fulfillment of their fiduciary responsibilities to shareholders. Many of the problems faced by some U.S. financial institutions today are likely due to inadequate risk oversight and flawed linkages between pay and performance. While especially relevant to financial institutions, boards of all companies should consider reassessing the risk management programs used and the impact of executive compensation policies on the risk culture of the organization. The issue of pay for performance has been drawing increased attention and there are several steps boards can take to ensure compensation programs successfully balance these competing interests (Taylor, 2009).

The Basle Committee on Banking Regulation and Supervisory Practices asserted that: Public confidence in banks, and hence their stability, can be undermined by adverse publicity as a result of inadvertent association by banks with criminals. There is an increasing recognition of the negative impact which enormous flows of illicit money can have on the financial

sector. It is in this connection that banks may lay themselves open to direct losses from fraud, either through negligence in screening undesirable customers or where the integrity of their own officers have been undermined, through association with criminals (BIS, 2008)

The Bank of New York fired one of two executives suspended amid allegations that Russian mobsters had used accounts at the bank in a major money laundering operation. He was in charge of the bank's Eastern European operations in London. One of her roles at the bank, in terms of taking on new clients, was diligence and the money laundering aspects. Investigators suspect that billions of dollars were moved through accounts at the Bank of New York, partly through a company called Benex Worldwide Ltd. Investigators believe the total amount funneled through the bank may exceed \$10 billion (Associated Press, 1999)

Despite the efforts by the Nigerian Government to combat money laundering, it is clear that they can only achieve limited success. The current economic conditions have made it difficult for the Government to effectively police money laundering. Economic downturn, withdrawal of subsidies and externally influenced economic liberalization policies, encourage the Government of developing countries to embrace laundered money or at least turn a blind eye on it. Another negative consequence of the economic downturn is corruption. The prevailing harsh economic environment has greatly reduced the resistance of the law enforcement agents to corrupt practices. The underdeveloped nature of the infrastructure and financial system in developing countries also does not help matters. All these limit the ability of law enforcement agencies to combat money laundering (Chibuike, 2012).

The importance of corporate sector, stock market, and accounting profession are increasing day by day. The growing importance of corporate sector calls for its efficient working and greater transparency. But unfortunately the prevalence of creative accounting has become a constraint in the way of transparency. In spite of the guidelines provided by Companies Act, Department of Company Affairs (DCA), the Institute of Chartered Accountants of India (ICAI), Securities and Exchange Board of India (SEBI), there have been a number of accounting scandals in India since 1980s mainly due to creative accounting providing flexibility in accounting system. Enron, Adelphia, Tyco, Fannie Mae, Lehman Brothers and most recently Satyam are the examples of major corporate collapses strengthening the concept of creative accounting (Subhaji, 2010).

The selection and application of generally accepted accounting principles (GAAP) is flexible, leaving enough room for judgment in certain areas. We can consider the example of inventory valuation which offers a number of accounting policy choice and estimation decisions for the companies to prepare financial statements. Due to this flexibility the management can be creative in preparation of financial statements. In most cases the management judgment results in change of reported financial results from one direction to another which is generally referred to as employed move beyond the boundaries of GAAP, the actions may be termed as fraudulent. Fraudulent financial reporting carries a more negative stigma and connotes much greater deceit than what is implied by accounting actions considered only to be aggressive (Mulford and Comiskey, 2002). As compensation contract may align shareholder and manager interests, but that does not mean it is designed to prevent every counterproductive behavior that managers might be tempted to engage in. In fact, one byproduct of compensation schemes that are optimal from the viewpoint of shareholders is that they can create an incentive to undertake excessive risk—risk so high it can jeopardize the stability of the firm (Mulford and Comiskey, 2002).

In America, access to emergency liquidity facilities such as the Federal Reserve's Discount Window may also encourage risk-takers at financial institutions to mismanage portfolio liquidity by relying on shorter-term liabilities (which typically carry lower interest rates) to boost profits. If a firm becomes more risky—borrowing to invest in projects that have a high pay-off and a high probability of failing—the downside is borne by debt holders, whereas the upside is reaped by shareholders. In fact, the riskier the firm becomes, the greater the potential upside there is. Faced with such an incentive, managers might take on more risks in order to maximize shareholders' as well as their own expected payoffs (through both stocks and stock options), possibly at the expense of the debt holders. As a result, the firm's safety and soundness may be sacrificed as the probability of insolvency increases due to more risk-taking (Jian, Kent and Todd, 2011).

Firms that implement executive compensation plans based on performance generally create more ambitious and difficult strategies (Dow and Raposo, 2005) than companies that do not give this kind of compensation to their executives, and when the adoption of these compensation plans for CEOs is announced to the market, shareholders' wealth generally increases. In most cases, the market will respond positively because it believes that the CEO

will develop efforts to increment the firm's stock market value to the level that will guarantee that stock options will be exercised (Dow and Raposo, 2005).

Bhattacharyya and Morrill (2008) find out a negative relationship between managerial compensation and payout based on US data. The Bhattacharyya's model assumes that high quality managers retain more cash in corporation instead of distributing it to shareholders as dividends in order to invest in positive net present value opportunities while low quality managers distribute more dividends. Comparing managerial contracts, the higher quality managers get higher pay while the lower quality managers get less. Bhattacharyya and Morrill (2008) performed Tobit analysis in relation to managerial compensation and dividend payout in the US firms over the period 1992-2001 so as to document empirical support for hypothesis arising from his model developed in 2007. Consistent with the prediction of the Bhattacharyya's model, a positive (negative) relationship between earning retention ratio (dividend payout ratio) and managerial compensation was found.

In a study of the US banking market done by Chen, Steiner, and Whyte (2005), they examine if stock option based executive compensation induce increased risk taking in 68 US banks between the years 1992 and 2000. In order to give insight regarding the impact of the deregulation during the 1990s, the time period analyzed by Chen, Steiner, and Whyte (2005) started after Securities and Exchange Commission (SEC) required all firms to disclose information regarding executive compensation in their financial reports. The results of the study show a proof of an increase in the usage of option-based compensation in the banking industry, in a comparison with other industries. They also find that a larger proportion of stock options and larger stock option based managerial wealth, induced risk taking in the banking industry during the examined time period. The authors of the article points out that the positive relationship between risk level and the level of option based compensation is partly explained by the expansion in the investment opportunity set of banks arising from a more deregulated market. However, they found limited evidence supporting that increased option based managerial wealth increase the overall wealth of the shareholders.

According to Shleifer (2011), the 2008 global financial crisis originated primarily from the financial industry, and then in later stages developed into a more widespread economic crisis. Executive compensation practices in the financial sector were criticized most. While bank management continue being unaware of their risk. Tosi, Werner, Katz & Gomez-Mejia (2000)

mention that executives favor information asymmetry in their decision making process, as they prefer to pursue their own targets, which often do not coincide with shareholders’

Segerstrom (2008) argue that the relationship between firm risk taking and CEO compensation structure is important to conventional management compensation schemes and this is what motivates risk taking by only looking at return, without regard for the risk accepted in generating it. In fact, one byproduct of compensation schemes that are optimal from the viewpoint of shareholders is that they can create an incentive to undertake excessive risk—risk so high it can jeopardize the stability of the firm (Mulford and Comiskey, 2002). Bhattacharyya and Morrill (2008) in analyzing the relationship between managerial compensation and dividend pay-out posit that there is need to explore in detail the diverse risks that result from executive compensation and this clearly articulates the objective of this study.

2.4 Risk Characteristics

For the purpose of this study risk was characterized and represented by money laundering, non performing loans, creative accounting and dividend payout. These risk terms are defined and explained below.

Money laundering is the process by which the proceeds of the crime and the true ownership of those proceeds are concealed or made opaque so that the proceeds appear to come from a legitimate source (Peter, 2004).

Non-performing loan is a loan that is in default or close to being in default. Many loans become non-performing after being in default for 3 months, but this can depend on the contract terms. A loan is nonperforming when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue (CBK, 2011).

Creative accounting is also called earnings management. It refers to accounting practices that deviate from standard accounting practices. They are characterized by excessive complication and the use of novel ways of characterizing income, assets, or liabilities and the intent to influence readers towards the interpretations desired by the authors. The term generally refers

to systematic misrepresentation of the true income and assets of corporations or other organizations (Ignacio, 2009)

Dividend pay-out is the ratio or fraction of net income a firm pays to its stockholders in dividends. The payout ratio provides an idea of how well earnings support the dividend payments. This variable is taken as a risk because sometimes dividend pay-put may be targeted for the benefit of the executives at the expense of the owners of the company, the shareholders (Hornsgren & Harrison, 2008).

2.5 Risk and Executive Compensation

When analyzing the relationship between risk taking and executive 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 (Segerstrom, 2008). Burnison (2009) argues that the design of the compensation systems, especially in the financial industry, resulted in that; people were rewarded with large bonuses for gaming the system, creating artificial value, obfuscating, and taking on excessive levels of risk, all without sufficient skepticism or scrutiny. Considering the effects of financial deregulation on a financial firm's menu of expanded investment opportunities and industry competition, it is conceivable that a financial firm will have enhanced incentives to provide its CEO equity compensation with higher pay for performance sensitivity. Does this translate into higher level of risk-taking by financial firms? Evidence on this question has been rather mixed (Mehran and Rosenberg (2007).

Chen, Steiner, and Whyte (2005) state that the principal agent theory suggests that the risk level of the firm itself influences the executive compensation structure. Hence, a CEO of a risk loving company would naturally prefer fixed compensation to variable compensation in such a case. The compensation packages are also affected implicitly by the risk taking of the firm, since variable compensation might be based on the performance target measures of the firm. An additional approach suggests that a riskier company has more information asymmetry and therefore a better possibility for a CEO to gain from inside information, which results in that risk taking will have a positive effect on the magnitude of equity-based compensation usage (Chen, Steiner, and Whyte, 2005).

2.6 Conclusions from Literature Review

There is an extensive literature available on the determinants of executive compensation but the findings among the studies are not compatible with each other. Overall, most of the academic works on the determinants of CEO compensation emphasizes on economic determinants like firm size (measured in terms of total assets or sales), firm performance (measured by sales, profits, ROE, ROA, stockholders wealth) giving controversial and mixed results that lack the value of their practical applicability in firms. However the study looks at broader company issue on motivating factor that encourages higher pays with result to risk in commercial bank in Kenya

CHAPTER THREE : RESEARCH METHODOLOGY

3.1 Introduction

This chapter provides details about the methodology adopted to assist in achieving the research objectives. According to Newing (2011), a research methodology is concerned with what you will actually do in order to address the specific objectives and research questions you have developed. This chapter shall cover research design incorporating type of research, population, sampling technique, sample size, instruments, pilot test and data analysis.

3.2 Research Design

Newing (2011) states that the term research design is used both for the overall process described above (research methodology) and also, more specifically, for the research design structure. The latter is to do with how the data collection is structured. According to Lavrakas (2008), a research design is a general plan or strategy for conducting a research study to examine specific testable research questions of interest.

This study used descriptive survey research design. Orodho (2003) and Kothari (2004) describe a descriptive survey design as a design that seeks to portray accurately the characteristics of a particular individual, situation or a group. Descriptive research design has been used in other studies like Clarence (2010) in analysis of sociological analysis of youth inactivity in the Philippine while Saeed (2010) used it to study supply chain as well as risk management concepts on the oil industry and Moodley (2007) used it to investigate the impact of employee satisfaction levels on customer service in the service utility at Telkom South Africa. In view of the above descriptions and strengths, descriptive survey is the most appropriate design for this study.

3.3 Population

The population of this study was all forty three commercial banks and one mortgage institution licensed by the Central Bank of Kenya as at 31st December 2011 (Appendix II)

Burns and Grove (2003) describe population as all the elements that meet the criteria for inclusion in a study. Burns and Grove also state that population includes all elements that

meet certain criteria for inclusion in a study. Newing (2011) describes a population as the set of sampling units or cases that the researcher is interested in. In this study, there two types of population. These are target population and accessible population. Accessible population refers to the population in research to which the researchers can apply their conclusions (Castilo, 2009). Target population refers to the entire group of individuals or objects to which researcher are interested in generalizing the conclusions (Castilo, 2009).

3.4 Sampling Frame

The sampling frame for this study was the list of licensed commercial banks and mortgage finance institutions in operation in Kenya as at December, 2011 as they appear in the Central Bank of Kenya database (Appendix II). A sampling frame is a list of population from which a sample will be drawn (Learly, 2001). A sampling frame is the source material or device from which list of all elements within a population that can be sampled is drawn (Sarndal, Swensson & Wretman, 2003) and may include individuals, households or institutions. It's a published list in which or a set of directions for identifying a population (Borg and Gall, 2007).

3.5 Sample and Sampling Technique

This study used both stratified sampling and simple random sampling. Stratified random sampling was used in each bank to group respondents into three strata. The strata was that of executive management, senior management and middle management. Executive management are members of a bank who are members of the board, senior management are those employees who report directly to the chief executive officer and middle management are those who report to the senior management. Within each of the three strata simple random sampling was done to identify individual respondents who were issued with a questionnaire to respond to the research statements. Data on executive remuneration was the average of four years (2008-2011) while primary data on the dependent variables was collected through the questionnaire during the from July 2012 and concluded in August 2012.

Lavrakas (2008) describes a sample in a survey research context as a subset of elements drawn from a larger population. Kombo and Tromp (2009) and Kothari (2004) also describe a sample as a collection of units chosen from the universe to represent it. A sample is a subset of population (Hyndman, 2008). Marczyk, Dematteo, Festinger (2005) defined a sample as

subset of the population to be studied. Yang (2008) states that the word 'sample' refers to the subset of a population.

Sampling is the selection of a subset of individuals from within a population to yield some knowledge about the whole population, especially for the purposes of making predictions based on statistical inference. (Scott & Wild, 1986; Black, 2004; 2011). Its main advantages are cost, speed, accuracy and quality of the data (Adèr, Mellenbergh, & Hand, 2008). The sampling process comprises of defining the population, sampling frame, sampling method, sample size and sample plan. Lavrakas (2008) describes a sample in a survey research context as a subset of elements drawn from a larger population.

3.6 Data Collection Instrument and Procedure

Primary sources of evidence were used in order to obtain sufficient information and provide reasonable reliability of the results. Data and evidence collection was based on the analysis of primary data collected via questionnaires. The questionnaire contained statements for the respondents to express their opinion and through this methods it was to possible to collect complete and reliable information and to obtain a clear picture of the study problem. The questionnaire contained likert scaled statements. The questionnaires were issued to the respondents through informal self introduction. The individual respondents were identified via simple random sampling using internal informants.

3.7 Reliability and Validity

Researchers seek to make research questionnaire consistent, clear, and understandable by all. In addition, the questionnaire should achieve its goals. Therefore, reliability and validity should be measured.

3.7.1 Reliability

Reliability is the consistency of responses; the degree to which an instrument measures in the same way each time under the same conditions. Reliability is used to ensure internal consistency and to achieve high degree of homogeneity between questionnaire statements (Polit and Hunger,

1985). Reliability is broadly defined as the degree to which measures are free from error and therefore yield consistent results (Zikmund, 2003). Kurpius and Stafford (2006) concur by defining reliability as the trustworthiness or accuracy of measurement. The terms consistency and stability are also used when discussing reliability.

Reliability can be computed through different methods like test- retest reliability, internal consistency reliability, and equivalent forms reliability. Test-retest method is not a main method to use for measuring the reliability. It requires a lot of time which is not available in this research, and it is difficult to find the same sample each time. The equivalent forms method also requires a lot of time. In addition, questionnaire will be too long (questionnaire in this method has two forms). Therefore participants may not answer in truthfulness.

In this research, questionnaire reliability was checked by choosing internal consistency method. By using this method, we can measure the correlation between each item in the questionnaire and others. In addition, we do not need to perform more than one test, or to design two equivalent forms. Likert scale questionnaires use Cronbach alpha method as Alhamdani et. al. (2006) argued. Twenty respondents were sampled randomly to fill questionnaires to measure the reliability of the questionnaire. Cronbach alpha was calculated for all statements in the questionnaire. Cronbach alpha is a correlation coefficient between to sets of data. The results were used to establish the reliability of the questionnaire as a research tool. According Kurpius and Stafford (2006) reliability coefficient refers to the scores obtained on a test. A reliability coefficient of zero indicates that the test scores are unreliable. On the other hand the higher the reliability coefficient, the more reliable or accurate the test scores. A reliability coefficient is a numerical value that can range from zero to one. For research purposes, tests with a reliability score of 0.7 and above are accepted as reliable, whilst for clinical decision making, test scores of between 0.8 and 0.9 are acceptable (Kurpius & Stafford, 2006).

To test reliability of the questionnaire, twelve questionnaires were piloted and the responses input into SPSS and the results of the reliability test produced a Cronbach Alpha correlation coefficient of 0.724 Kurpius and Stafford (2006) recommend that a correlation coefficient should be around 0.70 for a newly developed tool. It can therefore be concluded that the reliability of the questionnaire is adequate and can be relied upon to produce information and results for study conclusions.

3.7.2 Validity

Validity measures what the research tool is measure; it ensures that the research tool is measuring what researchers attend to measure or want to measure (Polit and Hunger, 1985). There are three methods to measure the validity of the research tool, which are: content validity, criterion related validity, and construct validity. This research did not apply criterion related validity method because it needs a lot of time. This method needs to measure the behavior by questionnaire, and then waiting to observe the real behavior of participants.

The study employed content validity method. The validity of the questionnaire was tested through discussion with the two managers of two randomly selected banks. They proposed some few changes in the instruments which were incorporated to enhance its validity.

3.8 Data Processing and Analysis

This study is explanatory in nature. Content analysis method was used to analyse collected data. This method has been chosen because of its strength in compressing lengthy interviews and conversations. Data was classified into various themes for ease of analysis. Through this method conclusions were made by systematically and objectively identifying specified characteristics of information collected. Content analysis categorises phrases, describe the logical structure of expressions and ascertain associations, connotations, denotations, elocutionary forces and other interpretations (Mugenda & Mugenda, 2004). Data was analysed using statistical package for the social sciences (SPSS) version 19 to generate descriptive statistics, graphs and diagrams.

Simple linear regression model was used to analyse the data using statistical package for the social sciences (SPSS) version 19. The responses on the likert scale questionnaire were coded and input in the SPSS software. A simple regression model was used to measure the relationship between the independent variable and the dependent variables which are explained in the model. 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 correlation, coefficient of determination and the level of significance. The variables were measured using various indicators as outlined on appendix II. The basis of the relationships

advanced in the model is to establish how executive compensation can lead to risk taking tendencies among banking executives. Analysis of data using regression model has been used previously by Aduda (2011) in a study which investigated the relationship between executive compensation and firm performance in the Kenyan banking sector. Also Ngugi (2001) used a regression analysis in a study on the empirical analysis of interest rates spread in Kenya while Khawaja and Mulesh (2007) used regression analysis to identify the determinants of interest rates spread in Pakistan. The simple regression model adopted for the study is as follows:

$$Y_1 = a + \beta_1 (\text{Excom}) + \epsilon$$

$$Y_2 = a + \beta_2 (\text{Excom}) + \epsilon$$

$$Y_3 = a + \beta_3 (\text{Excom}) + \epsilon$$

$$Y_4 = a + \beta_4 (\text{Excom}) + \epsilon$$

Where: Excom = Executive compensation. In this case, board and top management compensation is used as a proxy for executive compensation given that most of the executive compensation is taken up by top management and executive directors and also due to the fact that the annual reports do not give a specific breakdown of amounts due to executive directors, non-executive directors and top management. Y_1 = non-performing loans, Y_2 = money laundering, Y_3 = creative accounting and Y_4 = dividend pay-out. In the model a is the constant term while the coefficient β_1 to β_4 was used to measure the sensitivity of the dependent variables (Y_1 , Y_2 , Y_3 & Y_4) to unit change in the explanatory variable (Excom). ϵ is the error term which captures the unexplained variations in the model.

CHAPTER FOUR: DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter presents and discusses the findings from data analysis. The response rate is presented first and then the sample characteristics and finally the results based on the specific objectives of the study.

4.2 Response Rate

The questionnaire was adjusted with responses and reviews from a discussion with two bank managers who assisted in improving its validity. After adjusting the questionnaire with the pilot test responses two research assistants were deployed to the field. The researcher with the assistance of the research assistants followed up on the issued questionnaires to ensure good response rate. The data for this study was collected and analysed within two and half months (June–August, 2012) using a questionnaire. The questionnaire was administered to 230 senior management employees of 43 commercial banks. Responses were received from 37 banks and 126 respondents. Out of the 230 questionnaires, 126 were successfully completed and returned to the researcher by respondents giving a response rate of 55% (n=126), a figure considered substantially sufficient for the study. At an institutional level there was a response rate of 86% (n=37) out of 43 banks. Saunders *et al*, (2007) suggest that an average response rate of 30% to 40% is reasonable for deliver and collect survey method. According to Mugenda and Mugenda (2003) a 50% response rate is adequate, 60% good and above 70% rated very good. This implies that basing on this assertion; the response rate in this case is adequate.

4.3 Sample Characteristics

Table 4.1: Age of Respondents

Age Bracket	Total
18-25Yrs	28
26-35Yrs	23
36-45Yrs	36
46-55Yrs	39
Total	126

Majority of the respondents are between the age of 36 to 55 years and which is also the age bracket for majority of the respondents within the executive and senior management ranks.

Table 4.2: Respondents Banking Sector Experience

Years	Total
Less than 1Yr	17
1-2Yrs	29
3-5Yrs	20
6-7Yrs	26
Over 7Yrs	34
Total	126

Table 4.2 shows the number of years that the study respondents had worked in the banking industry. The larger proportion had worked in the banking industry for a period above three years

4.4 Data Presentation

This section presents the results of data analysis and associated interpretations and discussions. The section is organized based on the specific objectives of the study which has four variables. The study sought to establish the extent to which executive compensation influence; non-performing loans, money laundering, creative accounting and dividend pay-out among Kenyan commercial banks.

4.4.1 Executive Compensation and Non Performing Loans

Table 4.3 below presents the frequencies and descriptive statistics for responses on the influence of executive compensation on non-performing loans. The percentages are calculated from a total of 126 respondents

Table 4.3: Frequencies & Descriptive Statistics - Non Performing Loans

Statement	%	%	%	%	%	Mean	Standard Deviation
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree		
CEO and top management encourage advancing as much loans as possible because their compensation is based on growth in the loan book	1.6	2.4	16.7	15.9	63.5	4.37	0.953
Management ensures all borrowers of loans go through a rigorous credit worthiness appraisal	4		17.5	16.7	61.9	4.33	1.026
Management encourages the bank the use of a formulas for assessing its loans risk appetite	1.6	2.4	17.5	19.8	58.7	4.32	0.952
Management encourages and ensures the bank lends only against adequate collateral	12.7		66.7	20.6		2.95	0.847
Managements directs that politicians are not appraised when borrowing loans from our bank	52.4	38.1	9.5			1.57	0.662
Management always ensures and applies has risk based pricing on all loan products	12.7		64.3	23		2.98	0.862
						3.42	0.884

The responses for the effect of executive compensation on non performing loans have yielded a mean score of 3.42 out of a maximum mean score of 5. This indicates that majority of the respondents agreed to the statements for the study objective.

A simple regression equation in the form of $Y_1 = a + \beta_1 (\text{Excom}) + \epsilon$ was used to test the relationship between the effect of executive compensation (Excom) on non-performing loans (Y_1). The SPSS regression output is presented below.

Table 4.4: Model Summary – Non-Performing Loans

Indicator	Coefficient
R	0.0280
R Square	0.0007
Adjusted R Square	-0.0277
Std. Error of the Estimate	0.60308

The model used to test the objective indicates that there is a very weak positive relationship between executive compensation and non performing loans which is represented by a correlation coefficient of $R = 0.028$. R square indicated the variations in the non- performing that can be explain by the predictor variable; executive compensation. Executive compensation explains a very insignificant variation of 0.07% of the changes in the non performing loans. This shows that there are other factors that lead to variations in the non-performing loans and they are captured by the error term in the model.

Table 4.5: Regression Coefficients – Non-Performing Loans

Indicators	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3.37	0.135		24.889	0.000
Executive compensation	0.000	0.001	-0.028	-0.166	0.869

The regression output shows that executive compensation is not a good predictor of non-performing loans. This is reflected by a beta of 0.000 which shows that a change in executive compensation does not influence change in the level of non-performing loans among Kenyan commercial banks. This is further supported by p value of 0.869 which is significantly greater than zero at level of significance of 0.05. This shows that executive compensation does not lead to variations in the level of non-performing loans among Kenyan commercial banks.

4.4.2 Executive Compensation and Money Laundering

Table 4.6: Frequencies & Descriptive Statistics - Money Laundering

Statement	%	%	%	%	%	Mean	Standard Deviation
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree		
CEO and top management encourage staff to hunt for any type of deposit because their annual bonus is based on growth of total deposits	16.7	21.4	55.6	5.6	0.8	2.52	0.865
Management ensures that huge deposits are subjected to Know Your Customer Process	3.2	0.8	15.9	21.4	58.7	4.32	0.985
Management ensures that all new deposit customers must have a referee to open a new account	52.4	38.1	9.5			1.57	0.662
All foreign transfers are checked against the UN terrorist list available on the Central Bank of Kenya website	4		17.5	16.7	61.9	4.33	1.026
The bank has anti-laundering policies	12.7		66.7	20.6		2.95	0.847
The bank at least once a year subjects all staff to money laundering training	4		16.7	43.7	35.7	4.07	0.94
Management encourage reporting of all suspicious transactions	3.2	0.8	16.7	46	33.3	4.06	0.906
						3.40	0.890

The frequencies to the responses on whether executive compensation influences money laundering is shown on table 4.5. The mean score for the responses is 3.4 which is greater than a mean score of 3 for neutral. This indicates that majority of the respondents agreed with the statements in the questionnaire for this section.

A simple regression model was also used to test objective. The model was stated as $Y_2 = a + \beta_2 (\text{Excom}) + \epsilon$ where Y_2 represents money laundering. The SPSS regression output is presented below.

Table 4.7: Model Summary – Money Laundering

Indicator	Coefficient
R	0.0041
R Square	0.0000
Adjusted R Square	-0.0286
Std. Error of the Estimate	0.4517

Table 4.6 shows the model fitness in predicting the influence of executive compensation on money laundering. There exists a very weak correlation between executive compensation and money laundering among Kenyan banks as indicated by correlation coefficients of 0.0041. An R square of 0.0000 indicates that executive compensation does not predict changes in money laundering among the Kenyan banks. These model characteristics are further complimented by the following regression coefficients.

Table 4.8: Regression Coefficients – Money Laundering

Indicator	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3.3582	0.1014		33.1172	0.0000
Executive compensation	0.0000	0.0005	-0.0041	-0.0240	0.9809

The coefficient for the predictor variable (executive compensation) is a negative of 0.0000 which indicates changes in the executive compensation does not lead to any money laundering among Kenyan banks. This is further supported by a level of significance of 0.9809 which is significantly different from zero and p value of 0.05. This indicates that executive compensation does not influence money laundering among Kenyan commercial banks.

4.4.3 Executive Compensation and Creative Accounting

Table 4.9: Frequencies & Descriptive Statistics - Creative Accounting

Statement	%	%	%	%	%	Mean	Standard Deviation
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree		
The bank has an effective and independent board audit committee	3.2	0.8	16.7	46.8	32.5	4.05	0.902
The internal auditor of the bank is independent and can question the management on all misrepresentation of figures	7.9		34.1	57.9		3.42	0.852
The management can manipulate the external auditors to declare fictitious profits	52.4	38.1	9.5			1.57	0.662
The CEO directs how much expense accruals to be done at the end of the year as a way to manipulate profits	28.6	61.9	9.5			1.81	0.589
The CEO and top management manipulate valuation of company assets to reflect good balance sheet growth	12.7	20.6	23	43.7		2.98	1.077
						2.77	0.816

The mean score for the effect of executive compensation on creative accounting is 2.77 which shows that majority of the respondents disagreed with the statements that were related to the assessment of the objective.

The effect of executive compensation on creative accounting was tested by use of a simple regression equation and the results for the model fit are outlined below.

Table 4.10: Model Summary – Creative Accounting

Indicator	Coefficient
R	0.0500
R Square	0.0025
Adjusted R Square	-0.0260
Std. Error of the Estimate	0.5144

The simple regression was stated as follows; $Y_3 = a + \beta_3 (\text{Excom}) + \epsilon$. The results indicate a weak positive relationship between the actual values and predicted values of creative accounting which is represented by a correlation coefficient of $R = 0.05$. The coefficient of determination which is represented by R^2 of 0.0025 show that executive compensation explains on 0.25% of the variations in creative accounting and hence another huge percentage of variations is explained by other factors captured in the error term.

The regression output is shown below.

Table 4.11: Regression Coefficients – Creative Accounting

Indicator	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.6983	0.1155		23.3648	0.0000
Executive compensation	0.0002	0.0005	0.0500	0.2962	0.7688

The regression results show that the beta is 0.0002 which shows that a unit change in the executive compensation causes a very insignificant or very small change on creative accounting. The level of significance is 0.7688 and is significantly different from zero and hence larger than p value of 0.05. This indicates that executive compensation does not lead to creative accounting among Kenyan commercial banks.

4.4.4 Executive Compensation and Dividend Payout

Table 4.12: Frequencies & Descriptive Statistics – Dividend Pay-out

Statement	%	%	%	%	%	Mean	Standard Deviation
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree		
CEO and top management withhold dividends to reinvest in ventures that benefit them directly	29.4	61.9	7.9	0.8		1.8	0.607
CEO and top management have share options and ESOP and payout more dividends due to their vested interest	28.6	61.9	9.5			1.81	0.589
CEO and top management are guided by shareholder interest when proposing dividend payout	4		17.5	26.2	52.4	4.23	1.005
CEO and top management payout more dividends to influence shareholding in determining their remuneration	36.5	55.6	7.9			1.71	0.605
						2.39	0.702

The percentages on table 4.11 show the frequency of respondents among the 126 managers who returned the questionnaires. The mean score of the responses was 2.39 indicating that most of the respondents disagreed with the statements for this section.

The influence of executive compensation on dividend payout was also tested using a simple regression model and the coefficients for the model fitness are shown below.

Table 4.13: Model Summary – Dividend Pay-out

Indicator	Coefficient
R	0.0184
R Square	0.0003
Adjusted R Square	-0.0282
Std. Error of the Estimate	0.4643

The simple regression equation is stated as $Y_4 = a + \beta_4 (\text{Excom}) + \epsilon$. The results show a correlation coefficient of 0.0184 indicating a weak positive relationship between actual and predicted dividend payout. The coefficient of determination of 0.0003 indicates that executive compensation explains a very small aspect of variations in dividend pay-out.

Table 4.14: Regression Coefficients – Dividend Pay-out

Indicator	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.3245	0.1042		22.299 9	0.0000
Executive compensation	0.0051	0.0005	0.0184	0.1090	0.9138

The results indicate a beta of 0.0051 which shows that a unit change in executive compensation causes a very small change in dividend pay-out. This is further supported by the p value of 0.9138 which is significantly different from zero at a significance level of 0.05.

4.5 Summary and Interpretation of Findings

This study had four objectives and this section interprets and discusses the findings based on the objectives. The key findings are based on the coefficient of determination and the p value also called the level of significance.

The first objective was to find out the extent to which executive compensation influences the level of non-performing loans among Kenyan commercial banks. The findings of the regression analysis show that executive compensation explains a very small variation of 0.07% of the changes in the non performing loans among Kenyan commercial banks. The p value was found to be 0.869 which is significantly different from zero at level of significance of 0.05. This shows that executive compensation does not lead to variations in the level of non-performing loans among Kenyan commercial banks. This finding is inconsistent with a study done in China by Ernst & Young (2006) who found a relationship between the growing non-performing loans, bank failures and executive compensation.

The second objective was to evaluate the extent to which executive compensation influence money laundering practices among commercial banks in Kenya. Regression results produced R square of 0.0000 which indicates that executive compensation does not predict changes in money laundering among the Kenyan banks. This is further supported by a level of significance or p value of 0.9809 which is significantly different from zero at p value of 0.05. This indicates that executive compensation does not influence money laundering practices

among Kenyan commercial banks. Azul (2011) study of Mexican banks showed that management compensation and incentives had a direct link to laundering found at the Wachovia bank. The findings of this study disagree with Azul (2011) study. This could partly be explained by the level of vigilance that the Central Bank of Kenya has on commercial banks. A report by Associated Press (1999) on the Bank of New York found the management liable for laundering and was mainly due to the incentives the bank was offering the management based on growth of the balance sheet.

The third objective was to investigate whether executive compensation influences practices of creative accounting among commercial banks in Kenya. The coefficient of determination or R square of 0.0025 demonstrate that executive compensation explains only 0.25% of the variations in creative accounting and hence another huge percentage of variations is explained not captured by the predictor variable. The level of significance is 0.7688 and is significantly different from zero and hence larger than a significance level of 0.05. It can therefore be concluded that executive compensation does not encourage accounting malpractices among Kenyan commercial banks. This finding is different from a study done by Subhaji (2010) who found a direct relationship of executive remuneration and fraudulent accounting among companies like Enron, Adelphia, Tyco, Fannie Mae, Lehman Brothers and Satyam.

The fourth objective sought to establish whether executive remuneration influences management decisions on dividend pay-out. The regression output show coefficient of determination of 0.0003. This indicates that execution compensation explains an extremely small variation of the dividend pay-out decisions by management among commercial banks in Kenya. This is further supported by the p value of 0.9138 which is significantly different from zero at a significance level of 0.05. This leads to as conclusion that decisions for dividend pay-out among Kenyan commercial banks is not influenced by the extent of executive remuneration. This finding is similar to findings of a study by Bhattacharyya and Morrill (2008) who used a tobit analysis and found out a negative relationship between managerial compensation and dividend payout based on US data.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

This study set out to address four dependent variables (non-performing loans, money laundering, creative accounting and dividend pay-out) and one independent variable (executive compensation). The main objective was to establish whether executive compensation influences risk taking among Kenyan commercial banks. Risk taking was measured by use of statements on various aspects of bank operation which were the dependent variables of non-performing loans, money laundering, creative accounting and dividend pay-out. A questionnaire was used to gather information on risk taking. The independent variable was measured by use of the amount of executive compensation which is disclosed in the annual reports. Data was analysed by use of SPSS. The key model for deriving the variable relationships was simple linear regression.

The relationship between executive remuneration and non-performing loans produced a beta (0.000), the coefficient of determination (0.0007) and the p value (0.869). They all indicate that executive compensation does not influence non-performing loans in the Kenyan banking sector. Money laundering does not arise due to changes in executive remuneration among commercial banks in Kenya as indicated by the three indicators of beta (-0.000), coefficient of determination (0.000) and the p value (0.9809). Executive remuneration is not a contributor of accounting malpractices among Kenyan commercial banks. The beta (0.0002), coefficient of determination (0.0025) and the p value (0.7688) show a weak relationship between the/ independent and dependent variable. Dividend pay-out decisions among Kenyan commercial banks are not influence by the nature of executive compensation as indicated by the three coefficients of The beta (0.0051), coefficient of determination (0.0003) and the p value (0.9138)

5.2 Conclusions

Based on the findings and interpretations of results of data analysis it can be concluded that executive remuneration has does not contribute to risk taking among executives and senior management of commercial banks in Kenya. The measurement of risk taking was done using

four variables of non-performing loans, money laundering, creative accounting and dividend pay-out. Executive compensation was seen not to influence any of these dependent variables.

Non-performing loans among Kenyan banks are used to view the risk appetite and asset quality. This study had envisaged that there are bad loans being advanced by bank executives as a means of achieving targets for loan volumes and balance sheet growth. It is therefore evident that loans are advanced after careful prudent evaluations of the customers and management does not just approve loans for the sake of attaining performance targets and subsequent compensation.

Money laundering practices are a key risk in banks where competition for customers is quite fierce in an effort to improve liquidity and loanable funds. The respondents stated that the banks had adequate controls to mitigate any form of money laundering. This can be linked to efforts of the Central bank of Kenya of having regular supervision and surveillance on the operations of commercial banks.

Creative accounting can occur through manipulation of accruals and provisions for expenses and un-earned income. Many highly referenced corporate failures across the globe have been associated with fraudulent accounting practices which have been done with full approval from senior executives. In the case of Kenyan commercial banks the respondents disagreed with existence of accounting malpractices. This again can be attributed to the good oversight work of the Central bank of Kenya and the institute of certified public accountants who have spelt out punitive consequences for accounting malpractices. Banks can be deregistered by the Central bank and hence the cautioned taken the bank executives to ensure true, fair and objective reporting of financial performance of banks.

Dividend pay-out can be a risk if the management recommends dividend payment for own personal gain. It was found that Kenyan commercial banks management does not aim at personal gains when recommending to the shareholders on how much of dividend to pay. This can be partly explained by the fact that it is possible that the structure of compensation for bank management does not have much of equity compensation component and if it exist the decisions surrounding dividend pay-out are well controlled and managed.

5.3 Policy Recommendations

The findings of this study can be used to enhance existing policies within commercial banks and also other related institutions. The management of commercial banks will appreciate to note that their remuneration has not impacted the operations of banks negatively as per the findings of the study that executive compensation does not influence risk taking.

The management of the banks should continue to enhance the controls within operational areas that can pose a risk to the bank. The management actions should continue to be reviewed to ensure that they do not affect the banks business adversely. This will continue to guard against any negative effects and publicity that may arise from management actions.

Banking sector is sensitive by nature and a combined effort of the Central bank and commercial banks should continue to ensure that the integrity of bank executives is upheld. This will be important in ensuring the image of the sector continues to be of high regard among the customers.

The risk management functions of the banks and also the internal audit committee and department should continue to enhance their operations to ensure improved independence of operations and decisions. This will keep the executives on their toes using the oversight functions of such departments. These efforts should continue being supplemented by the surveillance and supervisory role of the Central bank.

5.4 Limitations of the Study

The study faced some limitations especially during the data collection phase. Majority of the sampled bank management employees expressed their unwillingness to participate in the study since they viewed it as a study sensitive to their work. However this limitation was countered giving assurance that all information will be treated with confidence and research ethics will be observed.

Due to budgetary and time constraints the study was limited to only four variables and used a sample to arrive at the conclusions. This was mitigated by ensuring that the sample selected was representative of the population and objective sampling methods were used to eliminate sampling biasness.

The study only concentrated with management staff which prevented an opportunity for other bank employees to put across their opinion on the objectives of this study. It is proposed that a future study on the subject matter can consider including some junior employees in order to capture their views which could add value to the study.

The instrument for data collection was only the questionnaire. Although the questionnaire was pilot tested this does not rule out instances of the respondents misinterpreting questionnaire statements and hence leading to spurious responses. This could have been minimized if there was an opportunity to use face to face instruments like interviews and focus group discussions. A similar study can use other information gathering instruments to supplement questionnaires.

5.5 Suggestion for Further Studies

In the course of this study several opportunities for further research presented themselves. This study can be replicated in other corporate entities in other sectors like manufacturing, tourism, savings and credit cooperatives and investment banks. A study can be conducted to establish the relationship between bank profitability and executive compensation. In view of the findings of this study that executive compensation does not influence risk taking, then there is need to establish the determinants of executive compensation among commercial banks in Kenya.

A cross sector comparison study can also be done in order to know which sectors have risks that are driven by executive compensation. This will help to tighten compensation policies in such sectors. A study can also be conducted to establish factor influencing risk taking among commercial banks in Kenya. This is informed by the fact that banking business has risk elements and the study will establish the risks being taken by management and the drivers behind such risk taking.

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APPENDICES

Appendix I: Questionnaire

This questionnaire is meant to gather information regarding the relationship between executive compensation and risks among listed commercial banks in Kenya

CONFIDENTIALITY CLAUSE:

The responses you provide will be used for academic purposes and will be strictly confidential.

SECTION 1: BASIC INFORMATION

1) Name (Optional).....

2) Kindly indicate your age

18 to 25 years	[]	26 to 35 years	[]
36 - 45 years	[]	46 to 55 years	[]
Over 55 years	[]		

3) For how many years have you worked in the Banking sector?

Less than 1 Year	[]	1 -2 Years	[]
3 to 5 years	[]	6 to 7 years	[]
More than 7 years	[]		

SECTION 2: RELATIONSHIP BETWEEN EXECUTIVE COMPENSATION AND RISKS AMONG LISTED COMMERCIAL BANKS IN KENYA

Below are statements on the relationship between executive compensation and risks among listed commercial banks in Kenya. Kindly tick the statement as appropriate on your opinion on each statement. **Key: 1=strongly disagree, 2= disagree; 3=neutral; 4= agree; 5= strongly agree**

Statements	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
	1	2	3	4	5

NON-PERFORMING LOANS

The following statements are related to the relationship between executive compensation and non-performing loans. Kindly tick as appropriate on your opinion on each statement

CEO and top management encourage advancing as much loans as possible because their compensation is based on growth in the loan book					
Management ensures all borrowers of loans go through a rigorous credit worthiness appraisal					
Management encourages the bank the use of a formulas for assessing its loans risk appetite					
Management encourages and ensures the bank lends only against adequate collateral					
Managements directs that politicians are not appraised when borrowing loans from our bank					
Management always ensures and applies has risk based pricing on all loan products					

MONEY LAUNDERING

The following statements are related to the relationship between executive compensation and money launderings. Kindly tick as appropriate on your opinion on each statement

CEO and top management encourage staff to hunt for any type of deposit because their annual bonus is based on growth of total deposits					
Management ensures that huge deposits are subjected to Know Your Customer Process					
Management ensures that all new deposit customers must have a referee to open a new account					
All foreign transfers are checked against the UN terrorist list available on the Central Bank of Kenya website					
The bank has anti-laundering policies					

Statements	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
	1	2	3	4	5
The bank at least once a year subjects all staff to money laundering training					
Management encourage reporting of all suspicious transactions					

CREATIVE ACCOUNTING

The following statements are related to the relationship between executive compensation and creative accounting. Kindly tick as appropriate on your opinion on each statement

The bank has an effective and independent board audit committee					
The internal auditor of the bank is independent and can question the management on all misrepresentation of figures					
The management can manipulate the external auditors to declare fictitious profits					
The CEO directs how much expense accruals to be done at the end of the year as a way to manipulate profits					
The CEO and top management manipulate valuation of company assets to reflect good balance sheet growth					

DIVIDEND PAYOUT RATIO

The following statements are related to the relationship between executive compensation and dividend payout. Kindly tick as appropriate on your opinion on each statement

CEO and top management withhold dividends to reinvest in ventures that benefit them directly					
CEO and top management have share options and ESOP and payout more dividends due to their vested interest					
CEO and top management are guided by shareholder interest when proposing dividend payout					
CEO and top management payout more dividends to influence shareholding in determining their remuneration					

Appendix II: Operationalization Of Variables

Variable Name	Type of Variable	Indicators	Measurement of Indicators	Data Collection Method	Type of Scale	Type of Analysis	Level of Analysis
Executive Compensation	Independent Variable	Cash paid to executives Salaries Allowances Bonuses	Kenya shillings	Secondary data collection from annual reports	Nominal	Quantitative	Descriptive & Inferential statistics
Non Performing Loans	Dependent Variable	Loans in default Loan risk classification	Kenya shillings	Annual reports Questionnaire	Nominal	Quantitative & Qualitative	Descriptive and inferential statistics
Money Laundering	Dependent Variable	Anti laundering policy Types of laundering checks Suspicious reporting to CBK	Policy Internal checks Reports	Questionnaire	Ordinal	Quantitative & Qualitative	Descriptive and inferential statistics
Creative Accounting	Dependent Variable	Management of accruals & Provisions Independence of internal audit function Independence of external auditors	Policy on accruals	Questionnaire Informal interviews	Ordinal	Quantitative & Qualitative	Descriptive and inferential statistics
Dividend Payout Ratio	Dependent Variable	Dividend policy Amount of dividend paid	Policy Amount paid	Annual reports Questionnaire	Nominal & Ordinal scale	Quantitative & Qualitative	Descriptive and inferential statistics

Appendix III: List of Commercial Banks in Kenya

AS ON 31st DECEMBER 2011

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

(Source: Central Bank of Kenya 2012)