

**THE RELATIONSHIP BETWEEN EXECUTIVE
COMPENSATION AND FIRM PERFORMANCE IN
KENYAN BANKING INDUSTRY**

BY

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**A RESEARCH PROJECT REPORT SUBMITTED IN PARTIAL FULFILMENT
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STUDENT'S DECLARATION

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

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This research project has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

I would like to dedicate this research project to my entire family. There is no doubt in my mind that without their continued support and counsel I could not have completed this process.

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ABSTRACT

The study sought to examine the relationship between executive compensation and firm performance. The study considered functional form relationship between the level of executive remuneration and accounting performance measures by using a regression model that related pay and performance.

From the findings, the existence of the pay-performance puzzle was evident, more so, with regard to smaller banks. The study negates the role of performance in determining executive compensation, given the inverse and non-significant relationship between pay and performance among large banks. The study concludes that among the large Kenyan banks accounting measures of performance are not key considerations in determining executive compensation and that size is a key criteria in determining executive compensation as it was significantly but negatively related to compensation. The negative correlation suggests the capping of executive compensation to ensure maximization of returns to shareholders. As such, the interests of the executive directors are subordinated to those of the shareholders in keeping with the agency theory.

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LIST OF ACRONYMS

CDS:	Central Depository System
CEO:	Chief Executive Officer.
CEOREM:	Chief Executive Officer Remuneration.
IOS:	Investment opportunity sets.
SPSS:	Statistical Package for the Social Sciences.

CHAPTER ONE:

1.0 INTRODUCTION

1.1 Background of the Study

The relative importance of various factors used to measure the performance of agents should be related to how well each measure informs the principal about the agent's actual performance (Banker and Datar, 1989). For decades accounting measures have been used as primary indicators of managerial performance with prior research documenting a significant relationship between accounting based performance and executive compensation (Ittner, et al., 1997). Moreover, both the annual cash bonus based compensation has been linked to accounting based performance as well as numerous other attributes of the firm's governance structure (Core, et al., 1999).

The compensation literature suggests that most annual cash bonus plans for key executive officers are based in large part on accounting performance measures. There is also some relationship between accounting performance and stock based compensation in many firms since the pool of stock options or stock awards to be distributed each year is often based on annual accounting performance measures. The literature has also documented a high correlation in the total annual incentive pay amongst the top executives in each firm, and it is commonly assumed that what is observed for the CEO is representative of the incentive pay for the entire top management team for most entities (Gore et al. 2003; Ittner, et al., 1997).

Based on prior work, much of the current executive compensation literature examines the relationship between CEO compensation and accounting based performance. In addition, these studies have documented links between executive pay and other attributes of firms related to their governance structure. These governance related variables have included firm size, number of board members, number of outside directors, number of interlocking directors, whether the CEO is also the Board Chair, and other governance characteristics (Core, et al., 1999). And commonly, accounting based performance measures tend to explain much more of the variance in executive pay across firms and time than do the governance characteristics (Core, et al., 1999).

The relative importance of various factors used to measure the performance of agents should be related to how well each measure informs the principal about the agent's actual performance (Lambert and Larcker, 1987; Banker and Datar, 1989). For decades accounting measures have been used as primary indicators of managerial performance with prior research documenting a significant relation between accounting based performance and executive compensation (Antle and Smith, 1986, Ittner, et al., 1997). Moreover, both the annual cash bonus and the sum of the cash bonus plus stock based compensation have been linked to accounting based performance as well as numerous other attributes of the firm's governance structure (Core, et al., 1999).

The compensation aspect suggests that most annual cash bonus plans for key executive officers are based in large part on accounting performance measures (Ittner, et al., 1997). There is also some relation between accounting performance and stock based compensation in many firms since the pool of stock options or stock awards to be distributed each year is often based on annual accounting performance measures. There is a high degree of correlation in the total annual incentive pay amongst the top executives in each firm, and it is commonly assumed that what is observed for the CEO is representative of the incentive pay for the entire top management team for most entities (Antle & Smith, 1986; Gore, et al., 2003; Ittner, et al., 1997).

Accounting and finance has also extensively been debated on as to whether accounting information should be used to measure managerial performance (Bushman and Indjejikian, 1993; Kim and Suh, 1993; Sloan, 1993). Because of the shareholders' interest in maximizing the value of their shares, arguments have been made that only share price should be used to evaluate performance. Managers are typically rewarded most by their share holdings in the employer entity. Recent evidence suggests that the annual cash pay of a majority of CEOs is less than 10% of the annual benefits from their stock options and stock holdings in the employer entity (Core, et al., 2003). However most research suggests that to both provide meaningful incentives for managers and also to then monitor their performance, accounting information is essential. The links between accounting performance measures and the current and future market value of the firm justify their use as a target that may be impacted by managerial performance.

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these studies have documented links between CEO pay and other attributes of firms related to their governance structure. These governance related variables have included firm size, number of board members, number of outside directors, number of interlocking directors, whether the CEO is also the Board Chair, and other governance characteristics (Core, et al., 1999). And commonly, accounting based performance measures tend to explain much more of the variance in executive pay across firms and time than do the governance characteristics (Core, et al., 1999).

The modern history of executive compensation research began in the early 1980s and paralleled the emergence and general acceptance of agency theory. The separation of ownership and control in modern corporations is, after all, the quintessential agency problem suggested by Berle and Means (1932) and formalized by Jensen and Meckling (1976), and the executive labor market is a natural laboratory for testing its implications. Early studies in this area focused on documenting the relationship between CEO pay and company performance (Coughlin and Schmidt, 1985; Murphy, 1985, 1986; Abowd, 1990; Leonard, 1990). Others examined whether CEOs are terminated following poor performance (Weisbach, 1988; Warner, Watts, and Wruck, 1988) and whether CEOs are rewarded for performance measured relative to the market or industry (Antle and Smith, 1986; Gibbons and Murphy, 1990).

Murphy (1999) provides a general overview of the literature, methodology and issues in executive compensation, starting from the influential study of Jensen and Murphy (1990), who first identified the pay-performance puzzle: that there is little relationship between executive pay and company performance. Main et al (1996), Izan, Sidhu and Taylor (1998), and Benito and Conyon (1999) have confirmed these low pay performance sensitivities.

In the Kenyan banking scene executive remuneration has not come under massive spotlight perhaps due to the nature of executive compensation. As opposed to compensation in the more developed markets, executive compensation in Kenya appears to be limited to cash salary, allowances and cash bonuses as indicated in the various annual reports of listed banks. Share option issues have not come into play yet as stock options are not traded in the Kenyan stock market. Given that executive compensation is not tied to stock performance by way of stock options the motivation for executive performance is unlikely to emanate from the benefits of a rising stock price. Further, all

most all listed banks apply return on assets and return on equity as performance measures. Hence it is fair to conclude these are some of the key benchmarks that are used to set the goals of the executive performance are accounting based and thus the relationship between compensation and accounting based performance measures is likely to be more meaningful.

1.2 Statement of the Problem

The relationship between executive compensation and firm performance has been documented in the literature to date. The compensation studies suggests that pay performance sensitivities should vary systematically with firm size and CEO stature, with strongest sensitivities associated with executives in larger firms. Ideally, executive compensation and firm performance are perfectly correlated, but associative studies on executive compensation and performance have yielded mixed results.

Theory-based economic analyses, practice and evidence imply that CEO compensation is a function of accounting information. Many studies suggest that accounting measures are important in incentive contracts because, while stock price aggregates information about the firm efficiently, it aggregates the information about the manager's performance inefficiently (Lambert and Larcker 1987; Banker and Datar 1989). Other research argues that accounting-based contracts reduce non-outcome-related noise (Kim and Suh 1993), congruently aggregate information about the manager's efforts (Feltham and Xie 1994), shield managers from market wide factors in stock prices and serve as a device to extract valuable information about the manager's efforts from stock price (Baiman and Verrechia 1995). Empirical literature generally provides support to these studies that suggest that accounting measures are relevant for incentive purposes. Lambert and Larcker (1987) document a statistically significant contemporaneous relationship between accounting earnings and CEO cash compensation. Moreover, firm proxy statements often state that accounting-based measures are used in determining the CEO's annual bonus (Sloan 1993). Thus in general, stock market measures have been viewed as suffering from conceptual and methodological weaknesses as measures of CEO performance (Banker and Datar 1989).

On the other hand, several studies fail to produce evidence of a compensation-

performance relationship. According to O'Reilly et al., (1988); Fosberg, (1999); Muriithi (2004); Izan, Sidhu and Taylor (1998) there is no statistically significant, positive relationship between changes pay and performance. These studies provide mixed conclusions and fail to offer a strong consensus regarding the relationship between executive compensation and corporate performance. Further O'Neill (1997) finds a weak link between pay and performance among Australian banks.

This Study seeks to examine and document the pay-performance relationship between executive compensation and banking firms' performance in Kenya. Executive compensation in Kenya has received increasing attention, and this is a longitudinal study of Kenyan executives' pay, providing an assessment of the effect of accounting performance measurements on the pay-performance relationship over time. The banking industry provides an excellent setting for the study of incentive compatible compensation since banks have few tangible assets and large off-balance sheet positions, easily smoothed accounting returns, a weak market for corporate control, comparatively high profits and highly paid executives; banks are institutions in which owner-manager agency problems may flourish. Study therefore seeks to fill the gap by examining the sensitivity of any relationship between executive and measures of firm performance in Kenyan setting.

1.3 Research Objective

The general objective of this study is to measure the relationship between executive compensation and firm performance.

1.4 Significance of the Study

Stock Market Regulators

This study will provide an understanding of executive compensation and to contribute to a better understanding of some basic problems with our corporate governance system. A full understanding of the flaws in current compensation arrangements, and in the governance processes that have produced them, is necessary to enable the stock market regulators to craft laws that will minimize excess in executive compensation among listed firms.

Shareholders

Our corporate governance system gives boards' substantial power and counts on them to monitor and supervise company managers. As long as corporate directors are believed to carry out their tasks for the benefit of shareholders, current governance arrangements, which insulate boards from intervention by shareholders, appear acceptable. The analysis of the executive pay landscape casts doubt on the validity of this belief and on the wisdom of insulating boards from shareholders.

Scholars/Researchers

This study fills an important gap in the literature by providing rigorous econometric evidence on the pay performance relationships of Kenyan banking executives. In so doing, the study contributes to one of the most important recent public-policy debates in Africa, on corporate governance reform.

CHAPTER TWO: 2.0 LITERATURE REVIEW

2.1 Introduction

This chapter outlines the various pay-performance theories coupled with the effects of corporate governance and management ownership on executive compensation. It also assesses trends in executive compensation in Kenya and makes international comparisons. Thereafter, Empirical studies on executive compensation were highlighted and subsequently the literature gap was indicated. Finally, it concludes with a general summary of the key issues borne out in the chapter.

2.2 Pay-Performance Theories

From the employee's perspective, pay is the reward for labour, that is, the actual effort of producing goods or services. The precise nature of the payment varies greatly across workers, and may include not only monetary income paid shortly before or after the labour is supplied, but also deferred payments, such as pensions and holiday pay, together with non- monetary rewards such as health insurance and other fringe benefits which are often rated by employees as more valuable than their monetary equivalents (Dale-Olsen, 2006).

Social norms also play an important role. For employees, one's social status is often bound up with one's wage and even how it is paid (hourly, weekly or as an annual salary). It may have a direct bearing on the worker's well-being, not only in terms of what she can wear and eat, but in terms of what she can borrow, and how she is perceived by work colleagues, friends and relatives. Above all else, workers' well-being is highly correlated with perceptions of their pay relative to their peers (Brown et al., 2005).

Economic theory of executive pay has focused on the design of optimal compensation schemes to align the interests of hired managers and shareholders. Agency theory has identified several factors by which these interests may differ; including the level of effort exerted by the manager and problems resulting from the unobservability of the agent's relevant skills. The design of optimal compensation contracts essentially trades-off between different incentive problems and risk-sharing considerations. Research has also

been directed to the identification of proper performance standards for evaluation and compensation. There exist a strong linkage between accounting measures of return and top executive compensation (Lewellen and Huntsman, 1970 and Sloan, 1993).

Accordingly, the various studies carried out in the field of executive compensation appear to highlight two broad theories under which most theories fall, that is, agency based theories and non-agency theories of executive compensation based on social norms.

2.2.1 Accounting based agency theories

Theory-based economic analyses, practice and evidence imply that CEO compensation is a function of accounting information (in addition to other information e.g. stock price). Many studies suggest that accounting measures are important in incentive contracts because, while stock price aggregates information about the firm efficiently, it aggregates the information about the manager's performance inefficiently (Lambert and Larcker 1987; Banker and Datar 1989). Other research argues that accounting-based contracts reduce non-outcome-related noise (Bushman and Indjejikian 1993; Feltham and Xie 1994), congruently aggregate information about the manager's efforts (Feltham and Xie 1994), shield managers from market wide factors in stock prices and serve as a device to extract valuable information about the manager's efforts from stock price.

Boschen and Smith (1995), find that the compensation response to stock returns is positive, significant and persistent over time. Duru, Iyengar, and Thevaranjan (2002), extend the Boschen and Smith (1995), design to include accounting returns. They find that contemporaneous cash compensation depends more on accounting returns than on stock returns, thereby explaining the earlier research which was primarily based on cash compensation. However, consistent with the more recent research, they find the contemporaneous relation between total compensation and accounting returns to be generally insignificant. They conclude that the contemporaneous characterization of the pay-performance relation overstates the impact of accounting returns and understates the effect of stock returns.

2.2.2 Component of earnings based agency theories

Natarajan (1996) investigates the role of components of earnings in CEO compensation

contracts. He argues that shareholders will use components of earnings as additional performance measures whenever the components provide information, over and above earnings, about managerial decisions. Results indicate that earnings and cash flow measures together have a better association with cash compensation paid to CEOs of U.S. companies than aggregate earnings alone. The evidence also suggests that current accruals and cash flows from operations are aggregated for performance evaluation. Stewardship value measures are able to explain some of the cross-sectional variation in the weights attached to earnings and working capital from operations.

An important stream of multi-period theoretical papers argues that residual income, defined as earnings less a charge for capital employed, is an optimal measure for managerial performance evaluation. Ohlson (1999) employ a multi-period principal-agent model to show that residual income is an optimal performance measure in a pure moral hazard setting with symmetric information. Because it measures value creation, Ohlson (1999) argues that compensation functions depend on the history of residual income. Continuing with the same theme but including the issue of asset valuation, Dutta and Reichelstein (1999) show that residual income, combined with fair value accounting for receivables, provides an optimal performance measure for incentive purposes. However, neither paper considers the agency problem of investment delegation.

Another stream of multi-period agency focuses on motivating long-term investments and ameliorating the problem of investment delegation. Rogerson (1997) and Reichelstein (2000) examine how by choosing a suitable depreciation schedule, pay based on periodic residual income motivates the manager to accept all projects with positive net present value. Dutta and Reichelstein (2000) studied a multi-period principal-agent model in which both the hidden action and investment delegation problems exist and found that residual income is the performance measure based on current accounting information that provides optimal investment and effort incentives if the relative benefit depreciation rule is used. Therefore, the residual income is the “optimal” accounting performance measure in compensation contracts.

2.2.3 Board capture based agency theories

One line of scholarship that endeavours to explain why there is not a strong relationship

between executive compensation and company performance is the “board capture” theory. Under this theory, the board of directors (and the remuneration committee of the board) is “captured” by the company’s CEO – with board dynamics and social dynamics discouraging non-executive directors from being overly demanding in formulating executive pay packages (Stapledon, 2004).

Newman and Mozes (1999) in their paper examines whether compensation committee composition affects CEO compensation practices. They find that CEOs receive preferential treatment (at shareholders' expense) when insiders are members of the compensation committee. They do not find that CEO compensation is greater in firms that have insiders on the compensation committee than it is in firms that do not. However, they show that the relation between CEO compensation and performance is more favourable toward the CEO (i.e., biased in the CEO's favor at shareholder expense) among the firms that have insiders on the compensation committee.

2.2.4 Management discretion based agency theories

In a parallel strand, recent studies in strategic management argue that managerial strategic discretion and the complexity of their job may be important determinants of executive compensation. Managerial discretion is defined as task complexity and the latitude of options top managers have in making strategic choices. *Ceteris paribus*, the larger the size of the company, the greater is the manager’s discretion to influence the absolute value of shareholders wealth (Lazear and Rosen’s 1981). Finkelstein and Boyd (1998) refer to managerial discretion as the extent to which an organization’s form and fate sit within the control of its top managers. Central to this concept is the idea that the greater the level of discretion, the greater the potential impact of actions taken by the executive on the firm and, hence, on the ability to directly influence its performance. Thus, executive compensation is expected to be higher in high discretion contexts, which is in accord with agency theory insights on the use of subjective measures.

Lambert and Larcker (1987), using growth rate in sales as a proxy for investment opportunity sets (IOS), found that the weight placed on accounting returns relative to stock returns in cross-sectional models of cash compensation decreases with the relative abundance of IOS, which is subject to management discretion. Sloan (1993), and Kim and

Suh (1993) investigate how corporate policies relate to investment opportunity sets of firms and find a relation between CEO compensation and proxies of IOS. Sloan (1993) postulates that all corporate policy choices (e.g. financing, dividend and compensation policies) are endogenously determined. The variations in IOS impact the optimality of these corporate policies. While Sloan (1993) tested the relation between IOS and these policies using industry data, John and John (1993) examined the same issue using firm-level data and found that firms with higher investment opportunities pay significantly higher cash compensation to their CEOs.

Baber et al. (1996) extend this stream of research by examining the effect of IOS on the sensitivity of compensation to market-based and accounting-based performance measures. Thus the incidence of IOS suggests a relatively high degree of information asymmetry between managers and shareholders and results in a higher dependence on incentive contracts. Further, the relative sensitivity of CEO compensation to stock returns versus accounting returns varies directly with the relative abundance of investment opportunities.

2.2.5 Social comparison based non-agency theories

O'Reilly et al. (1988) examined economic and psychological factors that influenced the setting of CEO compensation levels and tested both a tournament model and a social comparison model. Using data from 105 Fortune 500 firms, conventional economic determinants such as size and profitability were found to be only weakly related to CEO compensation. A test of a tournament model examined the difference in compensation between the top executive and those in the next hierarchical level. Controlling for other potential economic determinants, no support was found for this theory. Consistent with social comparison theory, however, strong associations were found between CEO compensation and the compensation level of outside members of the board of directors, especially those who serve on the compensation committee.

2.3 Effect of corporate governance

Governance structures have a strong influence on CEO compensation. They determine the company's exposure to the market for corporate control through their policy decisions

(Jensen and Murphy (1990) and therefore how contracts influence CEO behavior. Internal governance bodies are also directly responsible for the design of CEO compensation contracts and this contracting process is one of company directors' main tasks.

Mululu (2005) indicates that governance structures are subject to more influence from the CEO and are correlated with higher levels of CEO compensation. Moreover, the boards' activity is positively related to the financial performance of firms suggesting that boards' activity is a value relevant to attribute in corporate governance. These findings are consistent with the presence of agency costs associated with weak governance, where the CEO exerts his bargaining power to extract rents at the expense of shareholders.

Many firms have complied with the recommendations such as splitting the role of the chairman and CEO, setting up a number of committees such as a remuneration and nomination committee, although very little change on the level of pay or the pay performance sensitivity (Canyon, 1997), Bentio, and Canyon, 1999), and Girma, et al. 2003). Muriithi (2004) finds no significant relationship between corporate governance and firm performance. He performs both descriptive statistics analysis and cross sectional multiple regression analysis on 44 companies quoted on the Nairobi Stock Exchange in the period between 1999 and 2003 and concludes that no measure of firm performance has a significant relationship with the incentives of executive board members.

A "Governance Index" is built based on four different aspects of the company's governance structure: 1.) CEO duality, 2.) Size of the board of directors, 3.) Managements' shareholdings and 4.) Block shareholders' holding. This index is used as a proxy measure of the effectiveness of corporate governance mechanism (Fosberg 1999). The firms identified by the governance index as under sounding governance outperform those under poor governance. The results indicate that the corporate governance index built is a valid measure in evaluating the effectiveness of corporate governance of firms in Taiwan (Fosberg 1999). He further demonstrates one additional application of the governance index constructed in this dissertation by showing that firms (identified by the governance index) with strong corporate governance mechanism effectively constrain the propensity of managers to engage in earnings management and improve the quality of reported earnings. Corporate governance is an effective monitoring device of the quality of financial reporting. Firms with poor governance structure are more likely to avoid reporting small losses by reporting small positive earnings. Furthermore, the magnitude

of abnormal accruals is significantly related to governance level. Firms with weak corporate governance structures are more likely to use discretionary accruals to raise reported earnings.

2.4 Effects of Managerial Ownership

The relationship between compensation, managerial ownership and firm performance is vital. Morck et al. (1988) suggest that managerial ownership (including stock options) is generally too low and that performance improves as a result of increased equity ownership. In contrast, Demsetz (1995) predict that there is no relationship between equilibrium levels of managerial ownership and firm performance. While Core et al. (2003) propose that there is a positive relationship between option grants and future operating performance; Larcker (2003) contends that this relationship is sensitive to 8alternative econometric approaches. These mixed results indicate the lack of a sufficiently powerful setting in which to observe a relationship between managerial ownership/option-based compensation and firm performance. In contrast, an off-equilibrium setting is likely to be sufficiently powerful to observe this relationship (Core et al. 2003). Core and Larcker (2002) identify such a setting, one in which managerial ownership appears to be too low and states that the adoption of mandatory managerial stock ownership plans results in an increase in operating performance and stock market returns.

2.5 Executive compensation in Kenya

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

Unlike in the US, where publicly listed firms are required to disclose information on top five

executives' compensation, Kenyan listed firms have typically publicly disclosed only aggregated total compensation of a firm's board of directors. This compensation is limited to cash compensation as share option issues have not come into play yet as such the NSE disclosure on shares is limited to bonus and rights issues to the general investing public (NSE Handbook, 2004). 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 NSE handbook (2004). Thus as per the NSE handbook, specific details of executive compensation are not required.

2.6 International Comparison

There is a growing interest from researchers (as well as practitioners) on the level and structure of executive compensation. Although many of the country-specific studies attempt international comparisons for example, Conyon and Schwalbach, (1997), contrast pay practices within ten European countries), such comparisons are made difficult by substantial heterogeneity in (1) available data; (2) regression specifications (including definitions of the dependent and independent variables); and (3) institutional details such as tax and exchange rates, and restrictions on insider trading (Hebner and Kato (1997).

Abowd and Bognanno (1995), used data from four international consulting firms to analyze 1984-1992 pay in twelve OECD countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the UK, and the US) as a comprehensive international comparison They adjust for tax rates (on both direct pay and perquisites), purchasing power, and public benefits, and find that pay for US CEOs exceeds pay in other countries even after adjusting for these differences. Interestingly,

they find that the “US premium” is limited to the CEO: there is no significant difference between US vs. international pay practices for lower-level executives and production workers.

Although the understanding of international differences in executive compensation practices is far from complete, several results emerge from the existing research. First, the elasticity of cash compensation to company size is remarkably constant across countries: Zhou (1999), for example, reports pay-size elasticities for the US, Japan, the UK, and Canada of .282, .247, .261, and .247, respectively. Second, the elasticity of cash compensation to stockprice performance, and the relation between CEO turnover and performance is roughly comparable in the US, Japan, and Germany (Kaplan, 1994a, 1994b, 1997). Third, stock-based incentives from stock options and stock ownership are much higher in the US than in other countries (Abowd and Bognanno, 1995; Kaplan, 1997).

Pay levels and structures are converging, reflecting an increasingly global market for managerial talent. Canadian and Mexican companies, for example, routinely include US companies in peer groups used to determine competitive pay levels. US companies routinely export pay practices (including stock option grants) to executives of foreign subsidiaries, putting pressure on the pay policies of local competitors. And, foreign companies acquiring US subsidiaries face huge internal pay inequities, often resolved by increasing home-country executive pay. In addition, legal prohibitions on granting executive stock options in Japan were lifted in April 1997, resulting in (or from) a swell of interest in US-style compensation (Murphy, 1995); interest in stock options is exploding elsewhere in the Pacific Rim and in Europe and Latin America.

The banking sector ignores variation in the structure of compensation across firms. An exception is Hermalin and Wallace (1996). Their motivation is the Jensen and Murphy (1990) result that a \$1000 increase in shareholder wealth leads to a \$3.25 increase in CEO pay, a sensitivity that is low given that agency problems is presumed to be important in affecting CEO behavior and that compensation should therefore have a strong performance-based component. Hermalin and Wallace argue that it is important to account for firm heterogeneity when quantifying the pay-performance relationship. Using a sample of thrifts from 1988-92, they control for a set of firm characteristics (market-model beta, insider shareholdings, tangible capital, and a measure of firm efficiency) and

find statistically and economically important pay-performance relationships. They also find that firm size and insider shareholdings have a direct effect on the contractual features of compensation contracts (Garen (1994)).

Some studies examine differences in the level of pay across executive positions (Conyon and Schwalbach (1997)), but little attention has been paid to differences in pay-performance relationships. Murphy (1986) estimates pay-performance relationships for Chairmen, CEOs, Presidents, and Vice Presidents using 1964-81 time-series data on individual executives from a sample of manufacturing firms and does not find a decline in the magnitude of the pay-performance relationship as the hierarchical ladder is descended. In contrast, Aggarwal and Samwick (1999) uses data from the 1990s and finds that managers with explicit divisional responsibility have lower pay-performance sensitivities than managers with broad oversight authority, who in turn have lower pay-performance sensitivities than CEOs.

Demsetz (1995) looks at pay-performance sensitivities for managers with different responsibilities. He evaluates the explanatory power of tournament pay as compared to productivity pay, using data on the level and structure of executive compensation at 100 manufacturing firms. Demsetz (1995) measures the relative importance of firm performance and firm size in explaining the level of executive compensation and finds that the relative importance of performance is stronger for higher levels of management. The empirical relationships that are tested are consistent with both theories, since both suggest that a single elasticity cannot adequately characterize the pay-performance relationship.

An experience of a bullish equity market coupled with improved economic prospects in all sectors of the economy, improved corporate earnings, introduction of Central Depository System (CDS) which in turn boosted liquidity and the stability of Kenya Shilling against major currencies during the period between 2000 and 2005 indicate that banking firms performed relatively well and consequently executive pay shifted.

2.7 Empirical Studies

Various academics from economics, finance, accounting, management and have contributed to the current state of empirical executive compensation literature. The vast majority of this

extensive research has emerged during the last 25 years, since before 1980s only a handful executive compensation studies were published, including works by Lewellen and Huntsman (1970). Since then empirical CEO compensation studies have been conducted within *economics* by studies such as those of Jensen and Murphy (1990) and Rosen (1990). We next survey the directly related empirical studies from the previous literature.

Lewellen and Huntsman (1970) analyse 50 US firms at three-year intervals beginning from 1942 to 1963. They find strong evidence that top executives' compensation is heavily dependent upon generation of profits. Their results also indicate that firm profits and stock market values are substantially more important in the determination of executive compensation than are firm sales.

Jensen and Murphy (1990) use CEO compensation data on a sample of 1,295 firms from 1974 to 1986. They estimate pay for performance models in first-differences to account how change in CEO compensation is related to change in shareholders' wealth. As a CEO compensation measure they use a broad measure of eight different components. They find that CEO pay-for-performance sensitivity has been modest and it has fallen in real terms from the 1930s: *"... on average, corporate America pays its most important leaders like bureaucrats ... The total change in all CEO wealth is \$3.25 per \$1,000 change in shareholder wealth for the full sample, \$1.85 for large firms, and \$8.05 for small firms. The largest CEO performance incentives come from ownership of their firm's stock."* Their paper is widely cited both in academic papers and in popular press, since it raised doubts whether the U.S. companies are managed efficiently.

Rosen (1990) surveys several independent empirical studies on CEO pay-for-performance. He concludes that the evidence from these studies suggests that the effect of stock returns on log compensation is in the 0.10-0.15 range. Rosen (1990) also summarises a variety of academic pay-for-firm size elasticity works for different time periods in the U.S. and the UK. He find some variation in CEO pay-for-firm size elasticities, but : *"...the relative uniformity of estimates across firms, industries, countries, and periods of time is notable and puzzling because the technology that sustains control and scale should vary across these disparate units of comparison. The estimated elasticities for all companies are not significantly different from $\beta = 0.3$."*

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

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

Conyon and Leech (1994) examine the determinants of a top director salary and bonus with a sample of 294 large UK listed firms between 1983 and 1986. They find a positive but very small pay elasticity estimate with respect to firm performance. For the median top director, a 10% increase in shareholder wealth corresponds to an increase in compensation of 375 pounds. Perhaps more importantly, they find evidence that firm sales are important factors in explaining the top directors pay: an estimated elasticity is approximately 7%. Another key finding is that ownership control and concentration decrease the level of a top director's pay, but these variables do not affect the growth of his pay.

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

Hall and Liebman (1998) use 15-year panel data on the large U.S. firms that contain detailed information on CEO compensation. With the data from 1980 to 1994 they find that CEO compensation is highly responsive to firm performance, if the value changes of CEO stock and option holdings are accounted for in empirical analysis: the elasticity of CEO compensation with respect to firm value is 3.9 for 1994, which is about 30 times larger than the previous elasticity estimates. Thus, Hall and Liebman's empirical evidence contradicts with previous studies, if the value changes of CEO stock and option holdings are accounted for in estimations. They also argue that CEO mean (median) compensation increased by 207% (146%) in real terms from 1980 to 1994. When using an analogous measure to Jensen and Murphy (1990), in 1994 the total change in CEO wealth is \$5.25 per \$1,000 change in

shareholder wealth. Although this degree of sensitivity may appear to be modest, Hall and Liebman show that CEO wealth may change millions of dollars for typical changes in firm value.

The majority of the previous empirical CEO compensation studies have focused on either the U.S or the UK firms due to better data on CEO compensation. For example, in the US publicly listed firms are required to disclose information on top five executives' compensation, whereas in the most European countries CEO compensation data have been aggregated jointly with the board of directors. However, this seems to be changing, since corporate governance regulations in Europe more often recommend publicly listed firms to disclose information on CEO compensation. Thus, for example, Randøy and Nielsen (2002) examine the relationship between firm performance, corporate governance and CEO compensation within Sweden and Norway in 1998 by using data on 120 Norwegian and 104 Swedish firms that are traded publicly. The empirical evidence, based on cross-section data, indicates statistically significant positive relationship between the size of the board and CEO compensation, foreign board membership and CEO compensation, and firm market capitalisation and CEO compensation. On the contrary, however, they do not find evidence that CEO compensation and firm performance are statistically related.

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.

One reason advanced for a weak pay-performance link is the board-capture theory (Stapledon 2004). Askary and Doucouliagos (2005) suggest that at least in the Australian banking sector, boards are not captured by CEOs. CEO pay is linked to performance. They find that directors' pay in the Australian banking sector is driven mainly by the size of the bank, board composition and lags in pay. Specifically, larger banks pay higher pay, on average, to directors, while those banks with a larger proportion of outside directors pay less.

Finally, an interesting and a well-documented empirical finding is the relative uniformity of CEO pay-for-firm size elasticity estimates. For example, Baker, Jensen and Murphy (1988) summarise the U.S. Conference Board data on the link between CEO cash compensation and firm sales from 1973 to 1983 and document elasticities in the 0.25-0.35 range. This is supported by Rosen (1990), who also summarises a variety of academic works for different time periods in the U.S. and the UK. He find some variation in CEO pay-for-firm size elasticities, but: “...*the relative uniformity of estimates across firms, industries, countries, and periods of time is notable and puzzling because the technology that sustains control and scale should vary across these disparate units of comparison. The estimated elasticities for all companies are not significantly different from $\beta = 0.3$.*” Recently Conyon and Murphy (2000) estimate the pay-for-firm size elasticities for the UK and the U.S. firms with 1997 data. Their findings support “the near uniformity elasticity hypothesis $\beta=0.3$ ” for the U.S. ($\beta=0.3$), but not for the UK ($\beta=0.2$).

Although the previous empirical CEO compensation studies commonly report near 0.3 point elasticity estimate for CEO pay-for-firm size, the studies do not explain what lies behind this phenomenon. Also, to the best of our knowledge, we are unfamiliar with any theoretical study, which could explain, why an elasticity coefficient is near 0.3 across different firms, industries, times and countries. The only explanation, which we are familiar with, is Davidson Consultants’ “Wage and Salary Administration in a Changing Economy” (1984). It describes interestingly, how one consulting firm set CEO pay-for-firm size elasticity coefficient: “*The general rule is that as sales volume doubles, executive pay increases by one-third*” (in Baker, Jensen and Murphy (1988)). If Davidson Consultants’ general rule represents a common practice among executive compensation consultants, it may explain surprising commonalities in the elasticity point estimates across firms, industries, times and countries.

2.8 Literature Gap

Jensen and Murphy (1990) suggested that there is little evidence that relative performance to other firms in the industry is an important source of managerial incentives. In contrast in their comprehensive study of relative performance evaluation, Gibbons and Murphy (1990) established that both industry and market relative performance played a role in shaping executive pay. They found that market performance had a stronger effect than

relative industry performance. Studies in the UK that have explored relative performance evaluation have found insignificant results. Main et al (1996) found sector performance rather than market performance was insignificant but had a negative sign. Benito and Conyon (1999) also included relative performance, which was negative but insignificant.

Other factors considered in the literature include level of firm risk and corporate governance measures. Argarwal and Samwick (1999), reports that the level of firm return variance is an important determinant in the level of remuneration and this was robust across other measures of firm risk. By not allowing for the level of firm risk the pay-performance relationship will be underestimated. Firms are more likely to tie executive remuneration to that of the market when the firm's return is less volatile in relation to the market. Garen (1994) showed that firms with higher levels of risk as measured by betas from a regression of firms' return on the market return paid their executives more in salary and less in incentive payments. This fits with principal agent theory since risk-averse executives should demand higher base salaries and less performance-related pay when risk is high, in order to avoid the risk.

Lambert and Larcker (1987) asserted that accounting measures are relevant for incentive purposes. Sloan (1993) document a statistically significant contemporaneous relation between accounting earnings and CEO cash compensation. Moreover, firm proxy statements often state that accounting-based measures are used in determining the CEO's annual bonus. Recently, however, some studies report that CEO total compensation is not significantly associated with accounting measures of performance. While Baber et al. (1996) and Core et al. (2003) find no evidence of a significant relation between accounting measures and managerial compensation, Hall and Liebman (1998) and Murphy (1999) show that CEO cash response to performance is only a small amount of the sensitivity to overall firm performance. These findings motivate fresh questions as to the relevance of accounting measures in executive compensation contracts.

Akhigbe and Ryan (1997) postulates that much attention has recently been directed toward the relationship between the performance of firms and compensation received by their respective CEOs. They assess this relationship for commercial banks, as regulatory and other industry-specific conditions can cause the performance-compensation linkage in the banking industry to differ from that of industrial firms. They find that the accumulated human capital of CEOs and the bank size are positively related to the total

compensation (including salary, bonus, and stock options) levels of bank CEOs. They also find a positive significant relationship between bank accounting performance proxies and CEO compensation level for all time horizons. Finally, they find a positive significant relationship between market-based performance proxy and bank compensation.

In the US Jensen and Murphy (1990) suggested that pay performance sensitivities had weakened since the 1930's. In contrast Hall and Liebman (1998) found that pay performance sensitivities had more than doubled since 1981. McKnight et al (2000) in the UK found the pay-performance relationship had weakened between 1983 and 1991, whereas Benito and Conyon (1999) suggested it had strengthened between 1985 and 1995. Conyon and Nicolais (1998) looked at a sample of small to medium firms using cash compensation, and found that smaller firms had weaker pay-performance sensitivity than found in studies featuring larger listed companies. Conyon and Sadler (2001) examined individual pay-performance sensitivities in and across firms as opposed to an average across all firms. They found that pay performance sensitivities varied across directors between and within firms. Also firms that have stronger corporate governance structures tend to have higher pay-performance sensitivities (Bertrand and Mullainathan, 2001).

Consequently, there is conflicting evidence as to whether the pay-performance relationship has weakened or strengthened over time. Further, in spite of the exploding interdisciplinary literature, executive compensation has received relatively scant attention from labor economists especially in emerging markets such as Kenya. As a result, this study intends to examine whether the pay-performance relationship in the case of Kenyan banks has weakened or strengthened in the course of time based on the pay-performance sensitivities.

2.9 Summary

Various studies carried out in the field of executive compensation can be classified into two broad theories under which most theories fall, that is, agency based theories and non-agency theories of executive compensation based on social norms. Some studies from these two broad categories appear to be in support of the existence of the pay-

performance puzzle: that there is little relationship between executive pay and company performance. On the other hand, several studies have also identified a strong relationship between executive compensation and performance. Accordingly, it is the intention of this study to establish whether the pay-performance puzzle exists in the Kenyan banking sector.

CHAPTER THREE: 3.0 RESEARCH METHODOLOGY

3.1 Introduction

The purpose of this study was to assess the relationship between executive compensation and firm performance. In this chapter, the research design, target population, data collection methodology and procedures as well as data analysis and data interpretations are covered.

3.2 Research Design

The research design used in this study was an empirical cross-sectional design. This is a study in which data is gathered systematically over a period of time in order to answer a research question. Data analysis was carried out to determine the sensitivity of executive pay to changes in bank performance.

3.3 Population and Sampling Design.

3.3.1 Population

The target population comprised of banking firms in Kenya listed in appendix 1. The population of the study was the 45 banks licensed by the Central Bank of Kenya as at the end of 2008.

3.3.2 Sample Design and Sample Size

3.3.2.1 Sampling Frame

A sampling frame as a list of all the elements from which the sample is drawn and is clearly related to the population. For the purpose of this study, the 13 banks, which are designated by the Central Bank of Kenya as large banks, were used as the sampling frame.

3.3.2.2 Sample size

Sampling is the process of selecting a number of individuals for a study in such a way that the individual selected represents the large group from which they are selected

(Mugenda & Mugenda, 2003). A sample is a small proportion of an entire population; a selection from the population. Sampling procedure may be defined as a systematic process of individuals for a study to represent the larger group from which they are selected. A sample size has a specific level of certainty called the level of confidence. The precision of estimate of the population or tolerable level of accuracy for any estimate made from the sample is called the confidence interval or margin of error. According to Saunders (2003), researchers normally work to a confidence level of 95%. In this study the sample size constituted ten banks for which executive remuneration data was available for the five-year period. Of this sample nine banks were listed – Barclays Bank, CFC Stanbic Bank, Co-operative Bank, Diamond Trust Bank, Equity Bank, Kenya Commercial Bank, National Bank, NIC Bank, Standard Chartered Bank – while the Investment and Mortgages Bank was not listed. These ten banks were categorized by Central Bank as large banks and in 2008 they comprised 71.8% of the total industry deposit base and net asset value base.

3.3.2.3 Sampling Technique

Schindler (2003) asserts that stratified sampling technique divides the population into sub populations and used systematic sampling on each stratum, where the results may be weighted and combined. Stratified sampling was used to group the banks into relatively homogeneous subgroups before sampling. The study period provides an excellent setting for the study since in Kenya during this period experienced a bullish equity market coupled with improved economic prospects in all sectors of the economy, improved corporate earnings, introduction of CDS which in turn boosted liquidity and the stability of Kenya Shilling against major currencies. Also this is also the period in which the Central Bank established a consistent format in the presentation of data on bank operations. Further, other sources of data such as the NSE annual reports data bank had missing data for the preceding years to 2004.

3.4 Justification

Even though the managerial labor market is small and specialized, there are ample reasons to encourage labor-oriented research in the area. Executive compensation offers opportunities to analyze many concepts central to labor economics, including incentives, marginal productivity, contracts, promotions, separations, and careers. Although compensation contracts are multi-dimensional and complex, the publicly available data

are relatively clean: detailed compensation data, in the form of directors' emoluments, among large banks is widely available and easily matched to company performance data.

3.5 Data Collection Methods

The study employed secondary data since the nature of data needed for the study could be sourced from historical sources.

3.6 Data Analysis

3.6.1 Model

Data analysis is the process of reducing accumulated data into a manageable size. It is done by developing summaries, applying statistical techniques and then using the results to derive various functions or explore relationships among variables or to determine if the results are consistent with their hypotheses or theories, then interpret these findings. A multiple regression model was employed on the accounting based measures of performance used in this study, so the variables will be described as dependent variables, and independent variables. A computer package SPSS (Statistical Package for the Social Sciences) was employed to solve the multiple regression equation used in this study.

Multiple regression use is aimed at establishing that a set of independent variables explains a proportion of the variance in a dependent variable at a significant level (through a significance test of R^2), and establishes the relative predictive importance of the independent variables (by comparing beta weights). To test the above hypotheses the study was conducted using the regression model approach outlined below. The most obvious comparison addressed the issue of whether compensation and accounting performance variables are significantly different within the study period. These test results were shown in tables and graphs.

In analyzing the effect of compensation structure on firm performance, following Mehran (1995), only realized compensation was considered. Analysis was performed using directors' emoluments as a proxy for executive compensation since the bulk of director emoluments go to executive compensation.

Because the existing literature investigating the executive pay-performance relationship uses a model to relate pay and performance, the study considered functional form

relationship between the level of executive remuneration and accounting performance measures.

The standard pay-performance relationship was obtained from the following regression model:

$$\text{CEOREM} = f(\text{Size, performance, opportunity})$$

$$\text{CEOREM} = a + b_1 \text{SIZE} + b_2 \text{PERFORMANCE} + b_3 \text{OPPORTUNITY}$$

Where:

CEOREM = Executive remuneration.

SIZE = Size is depicted by the banks' customer deposits since they are the source of both interest and non-interest revenue

PERFORMANCE = Performance is monitored by two indicators namely return on assets (ROA) and a relative performance indicator based on return on equity (ROE)

OPPORTUNITY = the future potential of the bank is highlighted by the core capital to deposits ratio which all banks must maintain above 8% failure to which they cannot grow their lending further. Thus their opportunity for future growth heavily relies on their ability to boost their core capital to deposits well above the 8% statutory minimum

Hence the regression equation can be broken down further as follows:

$$\text{CEOREM} = a + \beta_1 \text{LN (DEPOSITS)} + \beta_2 \text{ROA} + \beta_3 \text{C-ADEQUACY} + \beta_4 \text{IND-ROE}$$

Where:

CEOREM = Executive remuneration. In this case board remuneration is used as a proxy for executive remuneration given that most of the Board remuneration is taken up by executive directors and also due to the fact that the annual reports do not give a specific breakdown of amounts due to executive

		directors and non-executive directors
LN (DEPOSITS)	=	the natural log of customer deposits
ROA	=	Return on assets
C-ADEQUACY	=	Capital adequacy ratio based on core capital to deposits
IND-ROE	=	is a dummy variable that compares the returns of individual banks to those of the industry. The variable is 1 if the ROE of the bank is higher than that of the industry for a given year and 0 if the ROE is below the industry average

Coefficients β_1 , β_2 , β_3 and β_4 were used to measure the sensitivity of the dependent variable (CEOREM) to unit changes in the four explanatory variables.

CHAPTER FOUR: 4.0 DATA ANALYSIS AND FINDINGS

4.1 Descriptive Statistics

From the annual averages of the ten banks, as shown in table 1 below, it is evident that executive compensation (Directors' Emoluments) increased with increase in return on assets and bank size as indicated by customer deposits. Executive compensation also appeared to go in tandem with core capital implying a relationship between compensation and opportunity. Consequently, year-on-year averages are indicative of a positive relationship between executive compensation and performance, size and opportunity.

Table 1: Annual averages of key bank statistics

	Core Capital	Profit Before Tax	Gross Assets	Return on Assets (%)	S/holders' Equity	Return on Equity (%)	Customer Deposits	Directors' Emoluments
2004	3,750,371	1,179	46,026	2.27%	4,037	23.50%	31,296	43,684,600
2005	4,550,601	1,455	58,087	2.30%	5,044	25.20%	34,833	51,435,800
2006	5,025,980	1,970	66,585	2.82%	5,867	31.35%	39,882	58,131,800
2007	7,521,600	2,623	69,064	3.64%	8,453	29.93%	48,327	61,305,900
2008	9,746,800	3,372	87,624	3.86%	11,488	28.04%	62,009	75,201,700

From the data sample of the ten banks adopted in the study, the average executive remuneration was generally on the rise for the five year period to 2008 accompanied by a similar rise in pay volatility as reflected by the increasing standard deviation. The same can be said of the explanatory variables with the exception of core capital to deposits which witnessed a three year dip before leveling out at generally higher levels in 2008. From table 2 below it can generally be deduced that executive remuneration rose in tandem with a rising deposit base and increasing profitability as measured by return on assets.

Table 2: Descriptive statistics of key variables for the entire sector

	CEO remuneration		Size (Deposit base)		ROA		Core Capital to Deposits	
	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
2004	43,684,600	32,308,207	31,296	26,015	0.0227	0.0126	0.0572	0.0528
2005	51,435,800	36,100,607	34,833	25,925	0.0230	0.0114	0.0489	0.0273
2006	58,131,800	37,764,245	39,882	28,024	0.0282	0.0115	0.0488	0.0171
2007	61,305,900	35,284,492	48,327	31,157	0.0364	0.0082	0.0910	0.0949
2008	75,201,700	49,597,258	62,009	33,863	0.0386	0.0124	0.0791	0.0529
CAGR*	14.54%		18.64%		14.16%		8.43%	

*CAGR- Compounded annual growth rate

The mean remuneration for the top-tier banks with the largest deposit base, witnessed a gradual incline over the five year period to 2008 along with the marked increase in deposit base, asset returns and capital adequacy. Mean remuneration only grew by 8.66% while mean deposit base grew by 14.2% on a compounded annual growth basis as shown in table 3 below.

Table 3: Descriptive statistics of key variables for the top-tier banks

	CEO remuneration		Size (Deposit base)		ROA		Core Capital to Deposits	
	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
2004	56,383,400	40,642,131	51,814	21,371	0.0233	0.0180	0.0242	0.0302
2005	69,258,200	41,049,261	55,303	21,313	0.0234	0.0137	0.0436	0.0317
2006	71,638,000	34,705,655	61,410	24,565	0.0264	0.0127	0.0394	0.0171
2007	77,627,400	38,112,967	71,615	28,510	0.0374	0.0100	0.0460	0.0183
2008	78,613,000	19,486,625	88,110	28,575	0.0352	0.0134	0.0630	0.0361
CAGR*	8.66%		14.19%		10.91%		27.03%	

*CAGR- Compounded annual growth rate

The mean remuneration for the bottom-tier banks rose considerably over the five year period to 2008 with an equally considerable increase in deposit base and asset returns. The executive remuneration grew at a much faster rate compared to top-tier banks of 23.37% while the growth in deposits was also high at 35.1% as indicated in table 4.

Table 4: Descriptive statistics of key variables for the bottom-tier banks

	CEO remuneration		Size (Deposit base)		ROA		Core Capital to Deposits	
	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
2004	30,985,800	17,136,625	10,777	3,687	0.0222	0.0053	0.0902	0.0513
2005	33,613,400	21,288,128	14,364	3,233	0.0225	0.0103	0.0543	0.0246
2006	44,625,600	39,348,251	18,354	2,230	0.0300	0.0113	0.0583	0.0120
2007	44,984,400	26,127,819	25,039	3,952	0.0354	0.0071	0.1360	0.1218
2008	71,790,400	71,595,579	35,907	7,767	0.0420	0.0118	0.0952	0.0660
CAGR*	23.37%		35.10%		17.28%		1.34%	

*CAGR- Compounded annual growth rate

From the above descriptive statistics it can generally be deduced that the for the bigger banks executive remuneration appears to have grown in tandem with returns and future opportunity, as measured by capital adequacy, whereas for the relatively smaller banks executive remuneration growth outpaced growth in bank returns and future growth prospects.

4.2 Correlation Analysis

The Pearson's coefficient was used to verify the existence or non-existence of linear correlation between and among the quantitative variables as indicated above. Emolument and size do exhibit a somewhat strong link. However, there is little evidence of multicollinearity among the explanatory variables since the correlations among them are not very strong hence all the variables can be incorporated into the subsequent regression analysis.

TABLE 2: Correlation matrix table

	<i>Emoluments/ PBT (%)</i>	<i>Log of Deposits</i>	<i>ROA</i>	<i>Net Core Capital to Deposits</i>	<i>Relative Performance to Industry ROE</i>
Emoluments/ PBT (%)	1				
Size (Deposit base)	-0.5933	1			
ROA	-0.4377	0.3322	1		
Net Core Capital to Deposits	0.1089	-0.1374	0.4125	1	
Relative Performance to Industry ROE	-0.5045	0.3719	0.5081	-0.2552	1

4.3 Regression Analysis

TABLE 2: Regression results for the banking sector

	REGRESSION ANALYSIS					
	Total Sector		Top-Tier Banks		Bottom-Tier Banks	
	<i>Coefficients</i>	<i>P-value</i>	<i>Coefficients</i>	<i>P-value</i>	<i>Coefficients</i>	<i>P-value</i>
Intercept	0.3221	0.00002	0.0477	0.5621	0.5412	0.0080
Size (Deposit base)	-0.0238	0.0010*	0.0019	0.8149	-0.0456	0.0332*
ROA	-0.7507	0.1924	-0.4508	0.1671	-1.1941	0.3414
Relative Performance to Industry ROE	-0.0170	0.1979	-0.0160	0.0229*	-0.0216	0.3943
Net Core Capital to Deposits	0.0685	0.5472	-0.2933	0.0078*	0.1601	0.3709
<i>R</i> ²	0.4680		0.7540		0.4616	
<i>DW</i>	2.0313		1.7796		1.9157	

*Significance at the 5% level (p<0.05)

Regression results for all the ten banks constituting the sample, i.e. total sector, reveal that Size is negatively and significantly related to the determination of executive pay hence it contradicts earlier findings such as those of Rosen (1990) found pay-for-firm size elasticity to be positive and the estimated elasticities were not significantly different from 0.3 i.e. $\beta =$

0.3. In this study overall sensitivity of executive compensation to bank size was -0.0238, i.e. $\beta = -0.0238$.

With regard to firm performance two explanatory variables were tested namely return on assets (ROA) and relative performance to industry ROE which was essentially used to identify the firms that were able to register above industry average returns on equity. In both cases although the coefficients did not yield significant results they were found to be inversely related to executive compensation contrary to the expectations of a positive relationship. This was contrary to the findings of Main et al (1996) who found a strong positive relationship between increasing shareholder wealth and executive compensation.

On the other hand, the measure of firm opportunity, net core capital to deposits, yielded a positive non-significant relationship to executive pay. The weak relationship between performance and pay generally points at the possibility of prevalent CEO capture of the boards throughout the industry.

The study also broke down the bank sample into two segments based on their size to assess whether there were any differences in the response of executive compensation to the explanatory variables between the largest banks (Top-tier) and their relatively smaller counter parts (bottom-tier) in terms of customer deposit base. In the case of the top-tier banks, relative performance to industry ROE and net core capital to deposits were found to be negatively and significantly related to executive compensation. This implies that performance and opportunity are key variables in explaining executive pay although in this case they are inversely related to compensation and is in agreement with Gibbons and Murphy (1990) who established the link between industry relative performance and executive pay. Thus for very large banks executive pay is negatively linked to performance and opportunity.

The bottom-tier banks exhibited trends similar to for the entire sector with size being negatively and significantly related to executive pay. Given that there is a weak link, as indicated by higher p-values, between performance and pay the results appear to suggest that for the small banks boards are susceptible to CEO capture. For the bigger banks, size has been growing much faster than remuneration whereas for the smaller banks remuneration is growing at a much faster pace, consequently the inverse relationship

between size and compensation.

4.4 Summary of Findings

Overall the study negates the role of performance in determining executive compensation, given the inverse and non-significant relationship between pay and performance among large banks, and as such its findings are in line with Jensen and Murphy (1990) and indicate the existence of the pay-performance puzzle: that there is little relationship between executive pay and company performance more so with regard to the smaller banks. For the bigger banks there is a significant but inverse relationship between pay and performance as well as pay and opportunity. As a result the executive pay for the biggest banks appears to be subdued to the overall goal of the bank, which is to post higher returns.

4.5 Implications of the Findings

The trade-off between returns and executive pay is in favor of returns. This may be due to the fact that two of the three biggest banks are foreign owned and as a result the executive's performance is based on returns to the foreign investors and in instances in which the firm's returns are faltering then the executive is also forced to take a pay-cut to maintain high return levels and keep their jobs. Even in instances of growing opportunity, the executive must cap his pay and subordinate his welfare to the bigger goal of higher firm returns.

Canyon and Leech (1994) found that ownership control and concentration decrease the level of a top director's pay, but these variables do not affect the growth of his pay. The study finds that for the small banks and the sector as a whole, size was found to be inversely related to executive compensation indicating that as the small banks get bigger, the ability of the family and CEO to influence the board with regard to pay diminishes as the smaller banks grow bigger. On the other hand, the smaller banks are generally founded by a group of families or local entrepreneurs who also happen to serve as executives or in some other executive capacity. To this extent the conflict between management and shareholder interests is diminished as the management and shareholders are to a large extent one and the same thing. Subsequently, the management may deem it more convenient to extract their dividends before they are subjected to corporate tax by bloating executive pay regardless of bank performance hence the findings contradict

those of Conyon and Leech (1994) whereby ownership was inversely related to executive compensation. This apparent CEO capture of the boards leads to inconsistencies between pay and performance and this may in turn leave the smaller shareholders who have no sway on board matters worse off.

CHAPTER FIVE: 5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The study 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 suggestions for further studies include the undertaking of a similar analysis over a longer time-span and the analysis of the relationship between executive compensation and firm value among listed banks.

5.2 Conclusions

The study finds a negative non-significant relationship between executive compensation and bank performance and as a result it indicates that among the large Kenyan banks accounting measures of performance are not key considerations in determining executive compensation.

In the large banking segment, size is a key criteria in determining executive compensation as it is significantly but negatively related to 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.

5.3 Policy Recommendations

In view of the research findings a negative relationship between executive compensation and size has been established and this has been attributed 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.

5.4 Limitations

The study only took into account a time span of five years to 2008 due to data inconsistencies emanating from available data from both the NSE data bank and the Central Bank.

The study had to rely on amalgamated data on board compensation which was inclusive of executive director compensation since the disclosure requirements do not require the banks to separate compensation between executive and non-executive directors.

Banks do not have sales rather they accrue interest and non-interest income and as such this study did not use sales as a proxy for bank size and instead opted to use customer deposits as they are the source of both interest and non-interest income.

5.4 Suggestion for further study

There is need for further studies to carry out similar tests for a longest time span going forward.

Similar studies should also be carried out on banks with total income (interest and non-interest income) as the proxy for size to try and assess whether the relationship between compensation and size is drastically altered by the change of variables.

Given that a good chunk of the studies touch on executive compensation and firm value, there is need to ascertain the relationship between the firm value of listed banks, as indicated by the share price, and executive compensation.

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Appendix 1: Banking Firms in Kenya

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

*(Source: Central Bank - October 4th 2007
<http://www.centralbank.go.ke/bankinfo/banks.asp>).*

Appendix 2: Key Operating Stats

2004		Core Capital	Profit Before Tax	Gross Assets	Return on Assets (%)	S/holders' Equity	Return on Equity (%)	Customer Deposits	Director's Emoluments
SIZE	BANK NAME	Kshs '000	Kshs 'mn	Kshs 'mn		Kshs 'mn		Kshs 'mn	Kshs
TOP TIER	Barclays Bank of Kenya Ltd	10,862,884	5,413	115,800	4.67%	12,485	43.36%	82,583	47,000,000
	Kenya Commercial Bank Ltd	5,191,373	2,691	70,310	3.83%	5,419	49.66%	56,971	124,819,000
	Standard Chartered Bank Ltd	7,716,691	1,076	81,797	1.32%	7,978	13.49%	54,560	57,529,000
	Co-operative Bank of Kenya Ltd	2,973,363	354	62,088	0.57%	3,299	10.72%	39,486	29,635,000
	National Bank of Kenya Ltd	2,077,745	743	59,727	1.24%	2,625	28.32%	25,470	22,934,000
BOTTOM TIER	National Industrial Credit Bank Ltd	2,192,587	354	18,474	1.91%	1,702	20.77%	14,268	45,781,000
	CFC Bank Ltd	2,349,601	373	17,549	2.12%	2,644	14.09%	12,788	42,496,000
	Investment & Mortgages Bank Ltd	1,709,983	372	15,664	2.37%	1,721	21.61%	12,554	5,781,000
	Diamond Trust Bank Kenya Ltd	1,146,525	193	11,691	1.65%	1,223	15.77%	9,203	20,756,000
	Equity Bank Ltd	1,282,954	218	7,161	3.05%	1,271	17.17%	5,074	40,115,000
Industry Average							22.86%		

2005		Core Capital	Profit Before Tax	Gross Assets	Return on Assets (%)	S/holders' Equity	Return on Equity (%)	Customer Deposits	Director's Emoluments
SIZE	BANK NAME	Kshs '000	Kshs 'mn	Kshs 'mn		Kshs 'mn		Kshs 'mn	Kshs
TOP TIER	Barclays Bank of Kenya Ltd	11,377,000	5,401.50	129,237	4.18%	13,177	40.99%	84,275	56,000,000
	Kenya Commercial Bank Ltd	9,801,739	1,908.60	104,487	1.83%	9,969	19.15%	61,062	75,082,000
	Standard Chartered Bank Ltd	8,388,022	3,500.30	104,274	3.36%	9,508	36.81%	59,996	136,512,000
	Co-operative Bank of Kenya Ltd	3,604,662	705.6	71,532	0.99%	4,057	17.39%	44,110	49,794,000
	National Bank of Kenya Ltd	2,731,907	859.1	65,211	1.32%	3,223	26.66%	27,071	28,903,000
BOTTOM TIER	National Industrial Credit Bank Ltd	2,385,338	403.3	23,349	1.73%	2,722	14.81%	16,988	56,444,000
	CFC Bank Ltd	2,574,695	417.6	27,171	1.54%	2,718	15.36%	16,696	52,421,000
	Investment & Mortgages Bank Ltd	1,892,904	489.4	24,515	2.00%	2,057	23.79%	15,307	8,200,000
	Diamond Trust Bank Kenya Ltd	1,336,784	363.5	18,749	1.94%	1,416	25.67%	13,779	16,548,000
	Equity Bank Ltd	1,412,957	500.5	12,341	4.06%	1,594	31.40%	9,048	34,454,000
Industry Average							23.97%		

2006		Core Capital	Profit Before Tax	Gross Assets	Return on Assets (%)	S/holders' Equity	Return on Equity (%)	Customer Deposits	Director's Emoluments
SIZE	BANK NAME	Kshs '000	Kshs 'mn	Kshs 'mn		Kshs 'mn		Kshs 'mn	Kshs

TOP TIER	Barclays Bank of Kenya Ltd	12,375,000	6,624	149,039	4.40%	14,862	44.57%	93,837	52,000,000
	Kenya Commercial Bank Ltd	9,168,805	3,035	115,592	2.60%	11,481	26.44%	71,495	92,920,000
	Standard Chartered Bank Ltd	8,367,299	3,798	114,162	3.30%	10,039	37.83%	64,879	121,331,000
	Co-operative Bank of Kenya Ltd	4,360,556	1,233	77,227	1.60%	4,810	25.64%	48,201	55,773,000
	National Bank of Kenya Ltd	3,367,504	934	70,125	1.30%	3,848	24.28%	28,639	36,166,000
BOTTOM TIER	National Industrial Credit Bank Ltd	2,699,536	675	29,240	2.30%	3,035	22.24%	21,978	44,425,000
	CFC Bank Ltd	2,765,391	679	31,869	2.10%	2,990	22.70%	18,507	109,805,000
	Investment & Mortgages Bank Ltd	2,424,097	936	30,054	3.10%	2,795	33.50%	18,220	8,750,000
	Diamond Trust Bank Kenya Ltd	2,530,617	685	26,153	2.60%	2,609	26.26%	16,726	19,253,000
	Equity Bank Ltd	2,200,993	1,100	22,391	4.90%	2,201	49.99%	16,337	40,895,000
Industry Average							28.31%		

2007		Core Capital	Profit Before Tax	Gross Assets	Return on Assets (%)	S/holders' Equity	Return on Equity (%)	Customer Deposits	Director's Emoluments
SIZE	BANK NAME	Kshs '000	Kshs 'mn	Kshs 'mn		Kshs 'mn		Kshs 'mn	Kshs
TOP TIER	Barclays Bank of Kenya Ltd	17,019,000	7,079	167,475	4.20%	17,564	40.30%	109,097	50,000,000
	Kenya Commercial Bank Ltd	10,046,000	3,863	124,527	3.10%	12,846	30.07%	85,638	113,769,000
	Standard Chartered Bank Ltd	8,967,000	4,897	92,966	5.30%	10,816	45.27%	73,841	124,150,000
	Co-operative Bank of Kenya Ltd	5,882,000	2,288	75,278	3.00%	6,807	33.61%	54,775	55,678,000
	National Bank of Kenya Ltd	4,442,000	1,610	52,098	3.10%	4,967	32.41%	34,722	44,540,000
BOTTOM TIER	National Industrial Credit Bank Ltd	13,666,000	2,364	54,640	4.30%	14,917	15.85%	31,536	73,000,000
	CFC Bank Ltd	4,058,000	1,048	32,673	3.20%	4,735	22.13%	24,806	52,042,000
	Investment & Mortgages Bank Ltd	3,750,000	1,294	30,389	4.30%	3,867	33.47%	23,626	12,380,000
	Diamond Trust Bank Kenya Ltd	4,279,000	869	31,130	2.80%	4,670	18.61%	24,409	23,380,000
	Equity Bank Ltd	3,107,000	921	29,467	3.10%	3,339	27.59%	20,820	64,120,000
Industry Average							28.04%		

2008		Core Capital	Profit Before Tax	Gross Assets	Return on Assets (%)	S/holders' Equity	Return on Equity (%)	Customer Deposits	Director's Emoluments
SIZE	BANK NAME	Kshs '000	Kshs 'mn	Kshs 'mn		Kshs 'mn		Kshs 'mn	Kshs
TOP TIER	Barclays Bank of Kenya Ltd	19,980,000	8,016	172,113	4.70%	20,463	39.20%	126,408	59,000,000
	Kenya Commercial Bank Ltd	16,187,000	5,394	181,974	3.00%	20,058	26.90%	109,845	108,227,000
	Standard Chartered Bank Ltd	9,332,000	4,709	100,392	4.70%	11,390	41.30%	76,898	87,365,000
	Co-operative Bank of Kenya Ltd	12,613,000	3,337	91,022	3.70%	13,933	23.90%	65,869	70,789,000
	National Bank of Kenya Ltd	5,952,000	1,313	85,450	1.50%	7,118	18.40%	61,529	67,684,000
BOTTOM TIER	National Industrial Credit Bank Ltd	14,272,000	4,757	78,001	6.10%	19,660	24.20%	48,977	194,000,000
	CFC Bank Ltd	5,672,000	1,797	44,588	4.00%	6,208	28.90%	34,278	49,797,000
	Investment & Mortgages Bank Ltd	5,070,000	1,474	43,609	3.40%	5,529	26.70%	35,238	71,225,000
	Diamond Trust Bank Kenya Ltd	4,457,000	1,305	42,073	3.10%	5,334	24.50%	32,689	29,690,000

Equity Bank Ltd	3,933,000	1,620	37,022	4.40%	5,188	31.20%	28,355	14,240,000
Industry Average						26.50%		

Appendix 3: Dependent and Explanatory Variables Stats

2004		Emoluments/ PBT (%)	Natural Log of Deposits	ROA	Net Core Capital to Deposits	Relative Performance to Industry ROE
SIZE	BANK NAME	Y _t	β ₁	β ₂	β ₃	β ₄
TOP TIER	Barclays Bank of Kenya Ltd	0.87%	11.321559	4.67%	5.15%	1
	Kenya Commercial Bank Ltd	4.64%	10.950298	3.83%	1.11%	1
	Standard Chartered Bank Ltd	5.35%	10.907056	1.32%	6.14%	0
	Co-operative Bank of Kenya Ltd	8.37%	10.583701	0.57%	-0.47%	0
	National Bank of Kenya Ltd	3.09%	10.145257	1.24%	0.16%	1
BOTTOM TIER	National Industrial Credit Bank Ltd	12.93%	9.5657745	1.91%	7.37%	0
	CFC Bank Ltd	11.39%	9.4562625	2.12%	10.37%	0
	Investment & Mortgages Bank Ltd	1.55%	9.4377946	2.37%	5.62%	0
	Diamond Trust Bank Kenya Ltd	10.75%	9.1272848	1.65%	4.46%	0
	Equity Bank Ltd	18.40%	8.5318847	3.05%	17.28%	0

2005		Emoluments/ PBT (%)	Natural Log of Deposits	ROA	Net Core Capital to Deposits	Relative Performance to Industry ROE
SIZE	BANK NAME	Y _t	β ₁	β ₂	β ₃	β ₄
TOP TIER	Barclays Bank of Kenya Ltd	1.04%	11.341841	4.18%	5.50%	1
	Kenya Commercial Bank Ltd	3.93%	11.019645	1.83%	8.05%	0
	Standard Chartered Bank Ltd	3.90%	11.002033	3.36%	5.98%	1
	Co-operative Bank of Kenya Ltd	7.06%	10.694442	0.99%	0.17%	0
	National Bank of Kenya Ltd	3.36%	10.206218	1.32%	2.09%	1
BOTTOM TIER	National Industrial Credit Bank Ltd	14.00%	9.7402625	1.73%	6.04%	0
	CFC Bank Ltd	12.55%	9.7229244	1.54%	7.42%	0
	Investment & Mortgages Bank Ltd	1.68%	9.6360655	2.00%	4.37%	0
	Diamond Trust Bank Kenya Ltd	4.55%	9.530901	1.94%	1.70%	1
	Equity Bank Ltd	6.88%	9.110299	4.06%	7.62%	1

2006		Emoluments/ PBT (%)	Natural Log of Deposits	ROA	Net Core Capital to Deposits	Relative Performance to Industry ROE
SIZE	BANK NAME	Y_t	β_1	β_2	β_3	β_4
TOP TIER	Barclays Bank of Kenya Ltd	0.79%	11.449315	4.40%	5.19%	1
	Kenya Commercial Bank Ltd	3.06%	11.177383	2.60%	4.82%	0
	Standard Chartered Bank Ltd	3.19%	11.080279	3.30%	4.90%	1
	Co-operative Bank of Kenya Ltd	4.52%	10.783135	1.60%	1.05%	0
	National Bank of Kenya Ltd	3.87%	10.262525	1.30%	3.76%	0
BOTTOM TIER	National Industrial Credit Bank Ltd	6.58%	9.9977972	2.30%	4.28%	0
	CFC Bank Ltd	16.17%	9.8259043	2.10%	6.94%	0
	Investment & Mortgages Bank Ltd	0.93%	9.8102752	3.10%	5.30%	1
	Diamond Trust Bank Kenya Ltd	2.81%	9.7247197	2.60%	7.13%	0
	Equity Bank Ltd	3.72%	9.7011878	4.90%	5.47%	1

2007		Emoluments/ PBT (%)	Natural Log of Deposits	ROA	Net Core Capital to Deposits	Relative Performance to Industry ROE
SIZE	BANK NAME	Y_t	β_1	β_2	β_3	β_4
TOP TIER	Barclays Bank of Kenya Ltd	0.71%	11.599993	4.20%	7.60%	1
	Kenya Commercial Bank Ltd	2.95%	11.357884	3.10%	3.73%	1
	Standard Chartered Bank Ltd	2.54%	11.209669	5.30%	4.14%	1
	Co-operative Bank of Kenya Ltd	2.43%	10.910989	3.00%	2.74%	1
	National Bank of Kenya Ltd	2.77%	10.455129	3.10%	4.79%	1
BOTTOM TIER	National Industrial Credit Bank Ltd	3.09%	10.358885	4.30%	35.33%	0
	CFC Bank Ltd	4.97%	10.118841	3.20%	8.36%	0
	Investment & Mortgages Bank Ltd	0.96%	10.070103	4.30%	7.87%	1
	Diamond Trust Bank Kenya Ltd	2.69%	10.102707	2.80%	9.53%	0
	Equity Bank Ltd	6.96%	9.9436693	3.10%	6.92%	0

2008		Emoluments/ PBT (%)	Natural Log of Deposits	ROA	Net Core Capital to Deposits	Relative Performance to Industry ROE
SIZE	BANK NAME	Y_t	β_1	β_2	β_3	β_4
TOP TIER	Barclays Bank of Kenya Ltd	0.74%	11.74727	4.70%	7.81%	1
	Kenya Commercial Bank Ltd	2.01%	11.606826	3.00%	6.74%	1
	Standard Chartered Bank Ltd	1.86%	11.250235	4.70%	4.14%	1
	Co-operative Bank of Kenya Ltd	2.12%	11.095423	3.70%	11.15%	0
	National Bank of Kenya Ltd	5.15%	11.027264	1.50%	1.67%	0

BOTTOM TIER	National Industrial Credit Bank Ltd	4.08%	10.799106	6.10%	21.14%	0
	CFC Bank Ltd	2.77%	10.442259	4.00%	8.55%	1
	Investment & Mortgages Bank Ltd	4.83%	10.46988	3.40%	6.39%	1
	Diamond Trust Bank Kenya Ltd	2.28%	10.394794	3.10%	5.63%	0
	Equity Bank Ltd	0.88%	10.252559	4.40%	5.87%	1

Appendix 4: Regression Analysis Stats

Sector Regression Statistics			<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Significance P-value</i>
Multiple R	0.68410	Intercept	0.32210	0.06819	4.72339	0.00002	*
R Square	0.46799	β_1	-0.02382	0.00679	-3.50858	0.00104	*
Adjusted R Square	0.42070	β_2	-0.75072	0.56732	-1.32329	0.19242	
Standard Error	0.03184	β_3	0.06847	0.11289	0.60654	0.54720	
Observations	50	β_4	-0.01703	0.01303	-1.30677	0.19793	

Top-Tier Regression Statistics			<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Significance P-value</i>
Multiple R	0.86834	Intercept	0.04770	0.08090	0.58955	0.56209	
R Square	0.75402	β_1	0.00186	0.00783	0.23722	0.81490	
Adjusted R Square	0.70483	β_2	-0.45083	0.31444	-1.43375	0.16709	
Standard Error	0.01048	β_3	-0.29331	0.09927	-2.95462	0.00784	*
Observations	25	β_4	-0.01596	0.00648	-2.46395	0.02293	*

Bottom-Tier Regression Statistics			<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Significance P-value</i>
Multiple R	0.67945	Intercept	0.54120	0.18385	2.94372	0.00803	*
R Square	0.46165	β_1	-0.04560	0.01994	-2.28703	0.03323	*
Adjusted R Square	0.35398	β_2	-1.19413	1.22533	-0.97454	0.34143	
Standard Error	0.04171	β_3	0.16008	0.17486	0.91546	0.37086	
Observations	25	β_4	-0.02160	0.02481	-0.87057	0.39432	