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EFFECT OF CEO PAY AND CEO POWER ON RISK-TAKING OF LISTED DEPOSIT MONEY BANKS IN NIGERIA

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Abstract

It has been argued that increasing demand for high compensation by executives and powers in the hand of executives have contributed to increased risk-taking in the banking industry. The study aims to examine the effect of CEO Pay, CEO Ownership Power, and Expert Power on risk-taking of listed deposit money banks in Nigeria. A sample of 12 deposit money banks for the period 2009 – 2019 was studied and analysed using panel regression. The study found that CEO pay and CEO Expert power have no significant effect on risk-taking of listed deposit money banks in Nigeria. In contrast, CEO Ownership power was found to influence risk-taking significantly. The study recommends strengthening the influence of independent directors on the board to mitigate the influence of powerful CEOs.

Keywords: Executive Compensation, powerful CEOs, compensation, CEO power, risk-taking.

1. Introduction

Over the years, advancements in technology have contributed towards financial integration, thus, affecting banking activities and operations. This advancement has also made competition among the industry players more strife, making banks devise means of staying in business, including greater risk-taking (Mamatzakis, Zhang, & Wang, 2017). This competition even became stiffer with the consolidation reforms in the banking industry around the world. The consolidation and deregulation exercises provided more funds for banks which saw the banks increasing their profitability through the increase in credit, creating a challenge for the industry (IMF, 2008; Altunbas, Manganelli, & Marques-Ibanez, 2011). The competition in the industry also led to an increase in demand for managerial talents, where the managers' remuneration depends on how much return on capital they can realise.

This means that a higher compensation offered by banks will be the only basis for attracting manager. For these managers to live up to the expectations of their employers, they tend to

take too much risk (Bannier, Feess, & Packham, 2012). The demand for highly talented managers capable of turning banks' fortunes has led to high compensation in the industry. This, in turn, has also put bank management under pressure to deliver on the shareholders' expectation of increased return. On the other hand, this expectation pushes bank managers to take too much risk (Bannier et al., 2012).

The banking industry has one of the most complicated implications of its risk-taking, as evidenced by the global financial crises. Shareholders pressure managers into risk-taking to maximise their wealth while creditors, and the society (taxpayers), on the other hand, are concerned about bank risk-taking. This becomes more important as the government guarantees certain bank liabilities, which can incentivize managers to take excessive risks at taxpayers' expense (Fortin, Goldberg, & Roth, 2010). Thus, bank managers' risk-taking attracts many stakeholders' interests due to the crucial financial role banks play in today's world. Cheng, Hong, and Scheinkman (2015) posit that executive compensation is correlated with risk; this is based on the principal-agent theory prediction that firms with more risk pay more compensation to equate the incentives for risk-taker and risk-averse managers. CEO pay in the banking industry is more aligned to shareholders' interests than in other industries (DeYoung, Peng, & Yan, 2013). The structure of CEO pay in levered firms like banks is believed to have encouraged excess risk-taking (Bolton, Mehran, & Shapiro, 2010).

On the other hand, powerful CEOs tend to exert their influence on the boards to make decisions, including risk-taking. CEO power can manifest through a firm's structure (CEO duality), executive ownership (CEO shareholding), executive expertise (CEO Tenure), or executive prestige (CEO Education) (Finkelstein, 1992). CEO shareholding in banks is believed to align the CEO interests with that of the shareholders (Fama & Jensen, 1983). Therefore, aligned CEOs tend to influence the board to take decisions towards increasing more risk (Srivastav & Hagendorff, 2016). In the same vein, CEO Tenure (Expert) power provides the CEO with information not necessarily available to other information users. Thus, such CEOs can use such information to exert influence on the board in decision making. In Nigeria, the powers exerted by bank's CEO came to the fore following the 2009 stress test; which revealed among others the influence bank CEOs have on operations of their banks, especially governance and risk-taking (Sanusi, 2011). Following this the CBN announced guidelines in limiting the tenure of managing directors of banks which led to some long tenured CEOs stepping. However, some of these CEOs were still able to come back to the boards as Chairmen due to the substantial shares they hold in the banks.

Studies on the relationship between CEO pay and risk-taking have been examined from two different perspectives. Some studies examined the relationship from the perspective of risk-taking as an influence on CEO pay; CEO pay is a dependent variable (Dittmann, Yu, & Zhang, 2017). The other perspectives studied CEO pay influencing risk-taking; that is, risk-taking is the dependent variable (Abrokwah, Hanig, & Schaffer, 2018). Studies in the second perspective are numerous, especially in the developed economies. This study aligns with the latter perspective. On the other, very few studies have looked at CEO pay and CEO power from a multi-dimensional approach to risk-taking. There is equally a dearth of literature examining the CEO power and CEO pay and risk-taking relationship in the Nigerian banking industry. This study examines the impact of CEO pay and CEO power on risk-taking of deposit money banks.

2. Review of Related Literature

Risk-taking refers to the choices organisations make that expose them to risk. Bank risk-taking is defined as choices made by banks that have tendencies to increase profits volatility (Nicolò, Dell'Ariccia, Laeven, & Valencia, 2010). It refers to a bank's actions where the outcome can turn out either good or bad, either getting a return or losing. Bank risk-taking can be a good risk where bank managers intend to enjoy rewards that can contribute to their profitability. Byrnes et al. (1999) argued that an action directed towards achieving an objective could only be referred to as risk-taking where such a decision will result in more than one possible outcome, and some of the outcomes are non-desirable. Therefore, bank risk-taking refers to banks' actions that make them vulnerable to risks, with conventional banks taking it up while Islamic banks share such risk. Bank risk-taking has been proxy by overall risk, credit risk and default risk. Overall risk-taking is believed to capture a bank's risk portfolio (Zhou, Kara, & Molyneux, 2017). The study adopts the overall risk as a proxy for risk-taking as it has been used extensively by regulators to measure risk-taking in banks (Luu, 2015)

Clementi and Cooley (2010) made a classical definition of CEO Pay as compensation paid to a CEO, which includes cash compensation determined at the inception of the contract, annual bonuses paid at year-end based on performances, and stock options as well as long term incentives. CEO pay can therefore be structured as cash-based, equity-based, or debt-based, or a combination of two or whole three (Hagendorff & Srivastav, 2017). CEO pay can be measured as total cash compensation, including salary and cash bonus (Amewu & Alagidede, 2019; Yu & Thuan, 2014), or total compensation that includes all cash and non-cash-based compensation (Cerasi & Oliviero, 2015; Shah, Akbar, Liu, Liu, & Cao, 2017). Considering that deposit money banks disclose cash compensation paid to CEOs, the study adopts the total cash compensation as a measure of CEO pay.

CEOs can become powerful from the influence they can exert on the board in decision-making. CEO power involves the CEO's ability to influence major decisions in a company even in the face of opposition (Adams, Almeida, & Ferreira, 2005; Halebian & Finkelstein, 1993). Finkelstein (1992) enumerated four classical sources of CEO power: structural power, ownership power, expert power, and prestige power. Structural power is proxy by CEO duality, ownership power is proxy by CEO shareholding, and expert power is proxy CEO tenure while prestige power is proxy by CEO education. This study adopts ownership power and expert power as proxies for CEO power as CEO duality is prohibited by the Corporate governance code in Nigeria. On the other hand, there are no adequate data for CEO prestige power. Studies have argued that CEOs with considerable shareholdings are more likely to influence a company's decisions in their ownership capacity. At the same time, expert power could result in CEOs exerting their influence on the board and other stakeholders (Daily & Johnson, 1997).

2.1 CEO Pay and Risk-Taking

Hagendorff and Vallascas (2011) analyse the impact of executive compensation on risk choices of bank CEOs using a sample of US banks. Measuring risk using Merton distance to default, the study found that CEOs whose pay-risk sensitivity is higher engages in risk-inducing mergers. DeYoung et al. (2013) examined commercial banks in the US over 1994-2006 and found that CEO incentives lead to riskier business policy decisions. Lu & Boateng (2017) examined CEO pay relationship with credit risk in the UK banking sector during the period 2000 – 2014 found that CEO pay has a positive and significant effect on credit risk.

However, Cheng et al. (2015) contend that the positive relationship between executive compensation and firm risk arises as a result of incentives offered to risk-averse managers for the extra risk they take. They also argued that riskier firms showed more productivity and are more attractive to institutional investors who can easily influence executive compensation. Swanepoel and Smit (2016) studied banks from the UK and US, and the study found that cash compensations decrease risk-taking while equity compensation increases risk-taking.

2.2 CEO Power and Risk-Taking

In a study of UAE banks during 2015 – 2018, Tadele and Kalyebara (2020), using Pearson pairwise correlation, found CEO power measured by CEO ownership increases risk-taking. The study, however, found a significant difference between the CEO power and risk-taking relationship between Islamic and conventional banks. Lewellyn and Muller-Kahle (2012) examined how CEO power influences risk-taking in US subprime lending institutions. The study found that CEO power has a positive and significant relationship with excessive risk-taking.

Altunbaş, Thornton, and Uymaz (2020) posited that risk-taking increases in banks with powerful CEOs. They argued that the relationship is influenced by the alignment of interests of CEOs and institutional investors. Thus, making it difficult for other executives to mitigate such risk-taking. However, Pathan (2009), in a study of bank holding companies in the US, found that CEO power negatively influences risk-taking in banks. In the same vein, Sheikh (2019) found that increase CEO shareholding serves as a disincentive to increase company risk. In the same vein, Fernandes, Farinha, Martins, and Mateus (2021) found that CEO power measured by CEO Tenure negatively influences risk-taking. It has therefore, been argued that powerful CEOs can exert great power in decision-making process. Thus, the extent to which a CEO decision can be very good or very bad can be determined by level of their influence on decision making (Adams et al., 2005; Luo, 2015).

The separation of management and owner in companies is believed to pose an agency problem. There is usually a conflict of interest between the owners and the management of the company. The owners expect the managers to act in their best interest towards maximising their value, whereas the managers are more interested in increasing their wealth (Jensen & Meckling, 1976). Managerial compensation is believed to help adjust the managers' interest with that of owners through appropriate incentives. These incentives have been argued to instigate the managers to increase risk-taking (Hoffmann, Hungenberg, & Mammen, 2012). However, Jensen & Meckling (1976) argued that this agency problem resulting from manager incentives is more pronounced when compensation is equity-based.

The Managerial Power Theory challenges the agency theory assumption of optimal contracting. It argues that in a practical sense, the board and executive do not necessarily engage in arm's-length transactions relating to compensation; thus, the alignment of managers and shareholders' interests may not happen (Bebchuk, Fried, & Walker, 2002). Powerful CEOs may distort the monitoring capacity of the board to the extent of significantly making control mechanisms ineffective (Benzing & Börner, 2015). Therefore, CEO power may make CEOs discretionary in influencing decisions; thus, the board's final decision would usually reflect the option of the CEO, which might be detrimental to the company's interest.

3. Research Methods

The study population is the deposit money banks listed on the Nigerian Stock Exchange (NSE) as of 31st December 2019. A total of 14 deposit money banks (DMBs) are listed on

the NSE on 31st December 2019. The study applied a filter by eliminating banks that were not in existence for the whole period of the study. This filter resulted in 12 DMBs. Thus, the study adopted the census of the adjusted population. Data were obtained from secondary sources and were hand collected from the annual reports and accounts of the DMBs under study. Multiple regression analysis using a panel regression model was used to analyse the data.

The dependent and independent variables are described, and their measurements are presented in Table I below.

Table I: Variable Description and Measurement

Variable Name & Acronym	Variable Measurement	Source(s)
<u>Dependent Variable</u> Risk-Taking (ORISK)	Proxy by overall risk-taking and measured by the ratio of total risk-weighted assets to total assets.	DeVita & Luo, 2018; Luu, 2015; Zhong, 2017
<u>Independent Variables</u> CEO Pay (LNCEOP)	Proxy by total cash compensation paid to a CEO which includes salary and cash bonus and measured by the natural logarithm of CEO pay.	Amewu & Alagidede, 2019; Yu & Thuan, 2014
CEO Shareholding (CEOSHR)	Proxy by shareholding of CEO as at the end of a financial year-end and measured as the ratio CEO shareholding to total shares.	Adams et al., 2005; Vo & Canil, 2019; Tadele & Kalyebara, 2020
CEO Tenure (LNCEOT)	Proxy by the natural logarithm of CEO Tenure and measured by the number of years a CEO has spent as CEO.	Vo & Canil, 2019; Fernandes, Farinha, Martins, & Mateus, 2021
<u>Control Variable</u> Performance (PROFT)	Proxy by return on equity and measured by the ratio of earnings to equity.	Abrokwah et al., 2018
Size (LNTA)	Proxy and measured by the natural logarithm of total assets	Tadele & Kalyebara, 2020

Source: Compiled from various literature, 2022

3.1 Model Specification

The study used a panel regression model to ascertain the relationship between the independent and dependent variables. The model specifies;

$$ORISK = \beta_0 + LNCEOP\beta_1 + CEOSHR\beta_2 + LNCEOT\beta_3 + PROFT\beta_4 + LNTA\beta_5 + \varepsilon_{it}$$

Where

- ORISK = Risk-Taking
- LNCEOP = Natural Logarithm of CEO Pay
- CEOSHR = CEO Shareholding
- LNCEOT = Natural Logarithm of CEO Tenure
- PROFT = Performance (Return on Equity)
- LNTA = Natural Logarithm of Total Assets

4. Results and Discussions

The results from the data obtained are presented and analysed in tables II-IV. The descriptive statistics are shown in Table II, the correlation matrix is presented in Table III, and the regression results are presented in Table IV.

Table 2: Descriptive Statistics

Variables	Obs	Mean	Std. Dev	Min	Max	Skewness	Kurtosis
ORISK	132	0.64243	0.13455	0.3162	0.9807	-0.08213	2.92393
CEOPAY	114	0.09606	0.06504	0.004	0.399	1.90597	8.90965
CEOSHR	129	0.00804	0.01918	0	0.09514	3.31672	13.7364
CEOTENURE	132	4.15909	3.12145	1	19	1.92152	8.85149
PROFT	132	0.04073	0.46087	-3.9375	1.09434	-6.05291	48.15399
TA	132	1626.92	1352.25	110.98	6311.04	1.39405	4.60871

Source: STATA Output, 2022

Table 2 shows that *ORISK*, a proxy for risk-taking, recorded an average of 64.24%, the least risk-taking amongst the banks during the period was 31.6%, while the highest was 98.07%. There is a lesser spread in the data as indicated by the standard deviation, indicating similarity in risk-taking among banks. Data are negatively skewed, meaning that data are located mainly on the low, while the kurtosis showed that data are not heavily tailed, indicating the absence of outliers.

The independent variable CEO PAY has a mean of ₦96 million, indicating that CEOs' average pay of listed DMBs in Nigeria is ₦96 million. The least paid CEO received ₦4 million as cash compensation, while the highest-paid received ₦399 million during the period. The standard deviation indicates a lesser spread in the data, while data are positively skewed, indicating that data are mostly on the high. In the same vein, CEOSHR had, on average, CEO shareholding of less than 1%, while some CEOs have no shareholding during the period, the highest shareholding by a CEO was 9.5%. The standard deviation showed a lesser spread in the data while data are mostly on the high as indicated by positive skewness. The data shows the possible presence of outliers as indicated by the high kurtosis.

Furthermore, the least CEO Tenure was one year while the highest was 19 years. On average, a CEO spends about four years. Standard deviation indicates the absence of significant variation amongst the tenure of CEOs. Data are skewed to the right, which suggests that most CEOs have spent more than the mean tenure during the period. On the other hand, PROFT on average was 4%, the lowest during the period was -3.9%, and the highest was 1.09%. The standard deviation indicates a high spread in the data; skewness indicates data is negatively skewed. TA recorded the highest total assets during the period of N6.3 trillion, with the lowest being N110.98 billion. On average, banks during the period had total assets of N1.6 trillion; standard deviation indicates little spread in the data. Data is positively skewed. An examination of the kurtosis for all the independent variables shows high kurtosis, which suggests the presence of outliers.

Table 3: Correlation Matrix

	ORISK	LNCEOP	CEOSHR	LNCEOT	PROFT	LNTA
ORISK	1					

LNCEOP	-0.0081	1				
CEOSHR	0.1519*	-0.0370	1			
LNCEOT	-0.0384	0.0508	0.1961**	1		
PROFT	-0.0300	0.3406***	0.0629	0.0520	1	
LNTA	-0.0143	0.5487***	0.1862**	0.0529	0.2748***	1

*, ** and *** indicates significant at 10%, 5% and 1% respectively

Source: STATA Output, 2022

Table 3 showed that the dependent variable ORISK is negatively correlated with LNCEOP, LNCEOT, PROFT, and LNTA but positively correlated with CEOSHR and significant at 10%. The relationship amongst the independent variables showed that LNCEOPAY is positively related to LNCEOT, PROFT, and LNTA, with PROFT and LNTA significant at 1%. However, LNCEOP is negatively associated with CEOSHR.

On the other hand, CEOSHR is positively and significantly related to LNCEOT and LNTA at 5% and positively associated with PROFT. In the same vein, LNCEOT is positively related to PROFT and LNTA while PROFT is significantly related to LNTA at 1%. The relationship between the independent variables did not indicate the presence of multicollinearity.

Table 4: Regression Results

Variables	Coefficients	t-statistics	p-value
Lnceop	-0.0149	-0.74	0.461
Ceoshr	1.3353	2.00	0.045
Lnceot	0.0046	-0.26	0.772
Proft	-0.0281	-1.68	0.092
Lnta	-0.0067	-0.39	0.696
R-Squared		0.8909	
Hausman		0.0001	
Panel Hetro		0.0000	
Wald Statistics		27.02***	

Figures in parenthesis represent t-statistics

***, **, * represent 1%, 5% and 10% significance respectively

Source: Stata Output, 2022

Table 4 presents the result of panel regression based on Panel Corrected Standard Error (PCSE). PCSE was found to be the most fitted model in the presence of panel heteroskedasticity and cross-sectional dependence. The model presents a Wald Chi-square of 27.02, which is significant at 1%; thus, the model is fitted. The independent variables account for 89% of the variation of the dependent variables as indicated by the R-Square.

Lnceop (CEO Pay) has a negative coefficient of 0.0149 but not significant. Indicating the absences of evidence to show that CEO pay influences risk-taking in DMBs. On the other hand, CEOSHR (CEO Shareholding) has a positive coefficient of 1.3353 and significant at 5%. Thus, indicating that CEO shareholding as a proxy for CEO power significantly influences risk-taking in DMBs. Lnceot (CEO Tenure) was found to have a positive coefficient of 0.0046 but not significant, indicating that CEO Tenure as a proxy for expert power does not significantly influence risk-taking in DMBs.

Examining the results of the control variables showed that Proft has a negative coefficient of 0.0281, which is significant at 10%. Thus, indicating that profitability negatively influences risk-taking in listed DMBs. LnTA was, however, found to have a negative coefficient of 0.0067 but not significant. The above results indicate that CEO Pay has no significant influence on the risk-taking of listed DMBs in Nigeria. Although not significant, the result tends to conform to the study of Swanepoel and Smit (2016) who argued that cash compensation tends to decrease risk-taking. In the same vein, CEO Expert power has no significant impact on risk-taking of listed DMBs.

On the other hand, CEO Ownership power was found to increase risk-taking significantly. This indicates that CEO Ownership in listed DMBs increases risk-taking tends to increase. The result conforms with Altunbaş et al. (2020), Lewellyn and Muller-Kahle (2012), and Tadele and Kalyebara (2020). The result is also in line with Managerial Power Theory, confirming that powerful CEOs can take decisions that are not necessarily in the interest of all stakeholders. The result can be explained from the point of view that CEOs with significant shareholding are most likely more interested in increasing shareholder wealth, which usually makes them take more risks.

5. Conclusions and Recommendations

Based on the findings, the study, therefore, concludes that there is no enough evidence to show that CEO pay significantly influence risk-taking. Consequently, cash compensation paid to CEOs of listed DMBs in Nigeria does not affect risk-taking. The study also concludes that CEO Tenure does not significantly alter the risk-taking behaviour of CEOs towards increased risk-taking. This can be linked to the possibility of long tenured CEOs who stepped aside due to CBN regulation of tenure limit coming back as Chairmen of the boards. However, the study concludes that CEO shareholding tends to alter CEOs' behaviour towards increased risk-taking. This is premised because CEOs with high shareholding tend to think more like a shareholder interest in increasing return on investment than an ordinary employee. For instance, the long tenured CEOs that returned to the board of banks as Chairman have large shareholding in the banks. Further confirming that high shareholding makes CEOs more powerful. Therefore, the study recommends the introduction of a policy by the CBN that can mitigate the influence of the powers of CEOs with large shareholdings. This can be done by increasing monitoring on the board by strengthening the influence of independent directors to mitigate the influence of powerful CEOs.

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