Journal of Organisational Studies and Innovation

Vol. 5, no.2, Summer, 2018

Do Corporate Governance Mechanism Influence CEO's Compensation? An Evidence from Pakistan's Banking Sector

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Abstract: Chief executive officers (CEOs) compensation is now a day's considered a highly debatable topic among academics and practitioners both. An extensive literature exits, that has examined multiple factors affecting the level of chief executive's remuneration. CEO is the most influential employee of an organization, who has the ability to create or deteriorate the company's value. To avoid the problem of agency cost, the most important task that a firm can do is to take into consideration the CEO's performance. It is the responsibility of the board of directors to oversee the CEO's performance, because better control by the board in the form of governance and an appropriate pay package for the CEO, can motivate the CEO to perform in the best interest of the shareholders and improve overall performance of the company. The decision made by the board regarding the CEO's compensation, can affect the performance of the firm either in the favour of the shareholder in form of more profit or it might lead to a loss situation for shareholders when a CEO gets compensated without keeping performance into consideration.

Understanding the complexity associated with CEO's remuneration, this paper is an extension of author's previous study, and is an attempt to highlight a developing country's perspective by identifying the mediating effect of the performance, bank size along with understanding the moderating effect of governance mechanisms on CEO's remuneration. Pakistan's Banking Sector represents a definite case of very high salaries and compensation packages, especially for the top level staff such as CEO and the directors.

This paper uses panel data of 22 listed banks in Pakistan for the period 2006-2013 and explores the model that best explains the relationship between CEO compensation and following variables: Firm Performance, Firm Size, CEO tenure, and Governance Mechanism.

Keywords: *CEO Compensation, Corporate Governance Mechanism, Banks*

Introduction

After the financial crisis of 2007, Chief Executive Officer's (CEO) compensation has gained attention of academician and practitioners all over the world. One important question that has been raised after this crisis is what role does governance mechanisms have in deciding salaries of company's top executives. These governance mechanisms include ownership and board structure of companies (Ozkan, 2011). The most widely used theory to explain any governance mechanism in literature is the Agency Theory. The theory highlights the contract between principals and agents, distinguishing that both the participants tend to have divergent interests, which they try to maximize. Agency theorists believe that contract arrangements (pay packages) may unjustifiably favour agents, and the resultant terms may be costly to owners (Beatty & Zajac, 1994; Tosi, Katz, & Gomez-Mejia, 1997; Westphal, 1998). Thus, there has to be ways to reduce the conflict of interest between managers and shareholders. Hence, governance mechanisms are considered to play a crucial role.

Managerial compensation has been subject of discussion since long. Earlier researches on managerial compensation have focused on the importance of corporate returns/performance

and firm size as major determinants. Agency Theory also supports a strong association between managerial compensation and firm performances, specifically in situations where boards apply outcome-based incentive contracts.

However, Managerial Power Theory negates Agency Theory by arguing that executive pay does not correlate to performance. In other words, high earners are not necessarily high performers. Later, the researchers from numerous countries have also revealed that despite steps taken to strengthen governance and to protect share holder interest, still the pay-for performance link for top executives either does not exists or, at best, is weakly positive (Tosi el al, 2000; Tai, 2004; Ozkan, 2011).

Alongside performance, recent focus of the researchers has been in explaining the question of managerial compensation by examining various aspects of corporate governance mechanisms. Recent studies on the governance mechanism suggests that more attention should be given to group dynamics of the boards i.e. board structure (Vandebeek et al, 2016). The most recent debated group dynamics of the board includes the role of institutional investors, managerial share holdings, independent directors, CEO of the family and board size (Bammens, Voordeckers, & Van Gils, 2011; Collin & Ahlberg, 2012; Zattoni, Gnan, & Huse, 2015).

If we analyse how governance mechanisms impact decision making in companies and how they have evolved over time to protect shareholder's right, we find the role of institutional investor to be on a rising trend. After financial crisis of 2007, institutional investors become more vocal in expressing their dissatisfaction regarding pay packages of top managers that were awarded, especially in the light of preceding poor performances.

Another important corporate governance variable highly debated in literature affecting decisions related to growth, capital structure and top managers' compensation is the presence of executive members' verses non-executive members on the board of the companies. Despite the substantial changes made by the regulators to the board structure of companies i.e. increasing the proportion of nonexecutive (outsider) directors on the company boards, there is still lack of evidence regarding efficiency of the board of directors. Thus, board of directors have been labelled as performing more of an advisory role rather than a monitoring role (Franks et al, 2001).

When it comes to monitoring in companies, it can be distinguished as external monitoring and internal monitoring. Internal monitors consist of the senior executives of a firm (Fama, 1980; Fama & Jensen, 1983; Rediker & Seth, 1995). As they manage the strategic corporate decision process, these executives may monitor each other in order to protect the value of their human capital in the managerial labour markets and to competitively ascend within the corporate hierarchy. On the other hand external monitors are actors who are not executives of the enterprise. They are required to perform the function of decision control in such a way so that costly executive decisions may be confronted.

This research mainly focuses on external monitors, including both independent institutions and board of directors. We believe that external monitors are needed to control the decisions of corporate insiders because, in agency theory, it is recognized that conflicts of interest are inherent in all contractual arrangements involving principals and agents. Work related to our arguments also suggests that monitoring in companies may be more vigilant with a higher proportion of independent outside directors, and with higher levels of investments by activist institutions (Beatty & Zajac, 1994; Booth & Deli, 1996; Ferris & Sarin, 2000; Hansen & Hill, 1991; Jensen & Meckling, 1976; Kochhar & David, 1996; Wright et al., 1996). Monitoring may alternatively be relaxed when the proportion of independent outside board members is low, and when the level of investment by institutions is low.

In this study, from an agency theory perspective, firstly we question whether returns (performance) directly or indirectly influence CEO compensation. Secondly, our debate is that does governance mechanisms affect CEO compensation. Lastly, we speculate that governance

mechanisms moderate the relationship between performance and CEO compensation. Hence, the contribution of our work is in providing fresh insights on the relationship between performance and senior executive compensation when performance directly fails to affect CEO's compensation. Also this study contributes to literature by looking at the moderating role of governance mechanism on CEO compensation. As identified through literature, this study focuses on independent directors, institutional investors, shares held by the board, CEO from family, and board size as governance mechanism criteria in the development of hypotheses

This paper is an attempt to highlight a developing country's perspective on justification and thereby identifying the factors that not only affect but also moderates CEO compensation. Several economists are of the opinion that conducting governance studies in developing countries is not possible. As elaborated by Gosh, (2006) developing economies as managerial markets are not well developed, also corporate laws, governance code, listing agreement and bankruptcy laws are also weak in these economies.

In case of Pakistan corporate governance code was implemented in 2002 for listed firms. Implementation of the code of corporate governance in Pakistan primarily falls within the ambit of two entities: the Security Exchange Commission of Pakistan and the State Bank of Pakistan. Pakistan's Banking Sector is the one of the most growing sector of the economy. This sector has been subject to reforms since 1990's. These reforms have resulted in making it more efficient and competitive. Apart from the most growing sector of the economy, Pakistan's Banking Sector represents a definite case of very high salaries and compensation packages, especially for the top level staff such as CEO and the directors.

Previous researches regarding CEO compensation in Pakistan has mainly focused on listed manufacturing companies, excluding financial sector due to non-availability of data (Shah et al, 2009; Athar &Khan, 2012). These studies either focused on corporate governance factors or only firm specific characteristics affecting CEO compensation in Pakistan.

This study contributes to the literature and is different from study previously conducted for Pakistan (Shat et al, 2009;Athar & Khan, 2012), by including both firm specific factors and governance factors and tries to find out the combined impact of these variables on the CEO compensation in banking industry of Pakistan. Also this study, departs from the agency theory and identifies the gap that traditional performance measures are not appropriate in economies where banking industry is based on deposit driven activities (Wayman.O, McKinsey, 2010). The data for the study has been hand collected from annual reports of the banks from 2006-2013. The study uses Structural Equation Modelling with firm performance, tenure, governance mechanisms (% of independent directors on the board, % of shares held by financial and non-financial institutions, board size, % of shares held by the board, CEO from family,) as explanatory variables.

The Section 2 of the study provides an overview of the relevant literature. Section 3 & 4 provides back ground of the problem and research hypothesis, Section 5 introduces the data and methodology while Section 6 presents the empirical results and their implications. Finally, Section 7 summarizes the conclusions of the study.

Literature Review

According to Murphy (1999), CEO pay packages can be divided into four basic components i) A base salary ii) An annual bonus plan which is tied to some accounting measure of the company e.g. performance iii) Stock options plans and other long term performance based incentive plans, such as restricted stock plans iv) CEO being part of the retirement plans offered by their companies receive special incentives in the form of gratuity/ provident funds. The basic salary is the definite component and other components of CEO compensation may vary depending on company policies

Researchers have explored many factors that are likely to impact CEO compensation. Findings about some of the most significant determinants of CEO compensation are discussed below.

Firm Performance

Historically firm performance has been considered as the most important variable affecting CEO compensation (Ozkan, 2009). Performance refers to the ability of a firm to earn and maintain profits/returns. Returns can be accounting returns or stock returns. Accounting returns are measured through ROA and ROE (Uneg, 2000), whereas stock returns refer to the stock price performance and is measured by looking at the market price of the firm's share (Hill, 1991).

In literature most of the studies have used one form of performance to find its impact on CEO compensation. Tai (2004) assessed the rapport between CEO's pay and their companies' stock performance. He reported a positive relationship between CEO pay and firms performance. On the other hand Boschen et al. (2003) examined the long run impact of rising accounting performance on CEO compensation and investigated whether accounting performance had a greater impact on CEO compensation than stock price. They reported that the two measures of performance had dissimilar long run effects on CEO compensation. They also found significant multi era dynamics i.e. CEO received no compensation for an unanticipated rise in accounting performance while in contrast they did receive a higher long run compensation for an unanticipated rise in stock price performance.

The impact of performance on CEO compensation has rarely been studied in isolation. The impact of performance on CEO compensation has been combined with corporate governance variable or firm specific variable. The most common firm specific variable used by researchers is firm size (Tai, 2004). Firm size is basically defined as how small or big an organization is in terms of its sales revenue and/or in terms of book value of the firm's asset. Ueng (2000) investigated CEO compensation for both small and larger size companies. The study defined small organizations as those that had assets less than $250 million and organizations that appeared on the *Fortune 500* companies were taken as large. It was reported that CEO pay was significantly related to firm size, CEO influence was not an important determinant of CEO compensation in small organizations while it was found to be significant determinant of CEO compensation in larger organization. Performance as measured by ROA was found in large companies to have an impact on CEO compensation.

Despite a significant amount of research done on firm's performance to affect CEO compensation, evidence on the extent to which firms link pay to stock returns is mixed. There are two explanations for the lack of strong evidence of a link between pay and stock returns. One explanation is that if board of directors are dominated by the firm's CEO, such boards are found to be incapable of enforcing a close link between CEO pay and stock returns (Hill & Pan, 1991). A second explanation for the mixed findings is the failure to explore the confounding impact of a number of contingencies on the link between pay and stock returns. Hill & Pan (1991) found the strength of the relationship between CEO pay and firm performance to be contingent due to ownership structure, with a much stronger link to be expected when stockholdings are concentrated and CEO tenure is longer.

Researches may give mixed and ambiguous result of performance and executive compensation, but practitioners are of the view that best practice codes are typically those that emphasizes on outcome-based incentives – that is, incentives linked objectively to either firm operating returns, market returns, or both. They believe that these returns act as optimal means through which boards can align the material interests of owners and executives. This view is in align with the concept of traditional Agency Theory of the firm, which has been pivotal in casting CEO pay-for-firm-level-performance as a key signifier of the board's commitment to aligning the interests of the CEO and shareholders (Abowd, 1990; Fama and Jensen, 1983; Grabke-Rundell and Gomez-Mejia, 2002; Jensen and Murphy, 1990; Levinthal, 1988).

Governance Mechanism

As mentioned above, the impact of performance on CEO compensation has rarely been studied in isolation. Most of the studies on CEO compensation has combined corporate governance variable with firm specific variable to capture the total affect. The governance variables includes ownership and board structure of companies (Ozkan, 2009)

Ozkan (2009) estimated the relationship between CEO compensation and company's performance while controlling for corporate governance variables. Ozkan believed that corporate governance factors reduce the agency conflict influencing compensation plans. The results showed a positive and considerable association between CEO compensation and company's performance and governance mechanisms.

However, after the financial crisis of 2007, studies on the governance mechanism suggested that more attention should be given to group dynamics of the boards. The emphasis of these studies was on identifying the underlying factors that explain the differences in board's role performance. The combined argument of these researches was that measuring an effective board structure is not an easy task, as board performance varies due to various reasons with as basic as if a company is privately held versus public limited companies (Bammens, Voordeckers, & Van Gils, 2011; Collin & Ahlberg, 2012; Zattoni, Gnan, & Huse, 2015)

Mejia et. al. (2003) did a research based on family controlled corporations. They tried to research various issues like i) whether family CEOs' receive low salary packages, ii) whether the concentration of family ownership in an organization effected compensation of their company's CEO negatively, iii) whether a large ratio of institutional investors effect the compensation of family CEO's negatively. Their results supported the hypothesis that in the long run family CEO's received less compensation than outside CEO's when family ownership increases. Secondly when institutional investors hold a large chunk of shares, family CEO received less compensation

Croci *et. al.* (2012) contributed by examining the effect of family ownership and institutional investors on chief executive officers' salary in continental Europe. Authors defined a business as family controlled, if a family member owned at least 10% of the shares. The finding suggested that for family owned companies, CEO was compensated far less than what a professional CEO would receive. Although institutional investors had a major part to play in impacting CEO compensation, but in continental Europe institutional investors were found not scrutinizing CEO compensation, which is contrary to earlier research. Also the preference of independent directors, CEO tenure and firm performance were found to have a negative impact on CEO compensation.

Furthermore, an important group dynamic that exists on the board and has been widely criticized is the board control i.e. how many shares are held by the members of the Board of Directors. The extent of board's control can be measured in various ways – firstly through CEO duality (when an individual is acting as a CEO and as a chairman to the board), second through the ratio of insiders members on the board (insider members are those directors who are also part of the firms' management).

Boyd (1994) hypothesized a framework for assessing CEO-board control relations. His research findings supported earlier studies describing the board as the key in-house control means for determining CEO compensation, thus aligning shareholder and management interests which reduces agency problems. The results revealed that board of director's remuneration had negative impact on CEO compensation whereas, board member's ownership positively affected board control. Institutional ownership was also found to have a positive impact on board control.

The literature on board structure also reveals an important dimension to compensation in which an issue is bought forward that as the CEO holds multiples positions in the organizations, i.e. act as a CEO and also the head of the board, he automatically gets placed at a higher position,

gets more authority in managing operations. Such CEO not only influence their pay packages, but tend to engage in merger and acquisition activities. Mergers and acquisitions are an attractive form of restructuring and reformation for a CEO as the enhanced availability of free cash flows in a post-merger firm adds to CEO power. It has been argued that in merger & acquisitions activities dual position CEO's tend to only benefit themselves by doing merger activities rather than improving organizational performance.

While researchers have been extensively working on finding the cause and effect on compensation, at the same time regulators needs to be given due credit in taking steps to strengthen the governance mechanism over time. The requirement that company directors should be materially 'independent' from the firm's hired managers is one of the hallmarks of contemporary corporate governance codes of best practice (e.g. Australian Stock Exchange Corporate Governance Council, 2003). Independent boards, independent chairpersons, and independent compensation committees are considered essential for good governance in general and, particularly, for optimal contacting between owners and executives. Independence, is assumed to facilitate board diligence and arms-length rationality across the director task range, particularly the management of Chief Executive Officer (CEO) performance and reward. Non-executive directors are typically perceived as being the standard of director independence. Bebchuk and Fried(2004) and Gumbel (2006) work, which was primarily based on Managerial Power Model of Governance, suggested that director independence act as a critical safeguard against managerial and board dominance as they act as representatives of shareholders interest. On the other hand, a number of studies have found that having outsiders or insiders makes no difference to the association between CEO pay and performance, or does very little to explain the variation in CEO pay levels and structures (Conyon, 2006; Murphy, 2002; O'Reilly & Main, 2007). Thus, growing body of research questions whether the combination of board independence and outcome-based incentives protect shareholders interest.

Another governance variable that is considered to reduce agency cost is the presence of institutional investors on the board. Institutional owners are considered as most powerful tool for influencing corporate governance in organizations (Wilcox, 2001). Institutional investors are defined as companies like banks and investment companies that collect money from general public investors and invest majorly in corporate shares company, thus have an impact on management decisions about CEO compensation package. Researchers believe that companies with large but few owners on board are more effective in reducing agency cost due to high stakes and comparatively low coordination costs compared to companies with dispersed individual ownership. Institutional owners have various formal and informal mechanisms such as their voting power, shareholder activism, and election of board members to influence management. Carleton et al (1998) suggested that large institutional investors may also negotiate in private with the management to take those steps that are consistent with the investors' interests. Finally, large institutional owners are believed to have more expertise and power compared with other large individual stockholders (Cubbin and Leech, 1983). Using a power perspective, researchers find that institutional investor involvement reduces top managements' influence on boards that set compensation (Bathala, 1996).

CEO Tenure

Principal agent problem has also been debated in light of chief executive officers (CEOs) influence over boards of directors. Arguments have been given where CEOs' compensation packages have been criticized to reflect their preferences of increase in pay packages compared to performance as CEO's tenure increases. Hill & Pan (1991) hypothesized that CEO's can influence the board. They researched the possibility that CEO compensation will be higher with longer the tenure of CEO in the company. The authors suggested that the longer the tenure of the CEO's the more dominant and authoritative they become to enforce their interests rather than that of the stockholders. The reasons given were that CEO's select the board members of

their choice and eliminate niggling members. Therefore the nominated board members owe their positions to the CEO's. In such instances board members have their loyalty towards the CEO's rather than to the stockholders. The study also found that long serving CEO's have more access to the internal information system and they manipulate information in their own favor. Such CEOs were found to be more interested in empire building and investing cash flows in projects that yield returns below the cost of capital in order to increase the size and scope of their firms.

Zheng (2010) explored the pattern of CEO compensation over the time an individual serves as a CEO in a particular organization in the US. The findings suggested that the board of directors in order to align manager and owner interest, put in more equity instruments into compensation compositions of the CEO's. However, as the CEO's tenure increases and board becomes familiar with CEO's ability, they reduce the equity based compensation. Also, long serving CEO's themselves become more interested in cash compensation rather than equity compensation. This study also highlighted the weakness of performance to compensation relationship as the CEO tenure increase.

Other variables that have been acknowledged in the literature, but have found to be less significant in affecting CEO compensation and cannot be studied in isolation are the role of compensation committees (Adut et al, 2003; Sun, 2004), and Organizational culture.

Banking Sector in Pakistan

Pakistan's banking sector reforms were initiated in the early 1990s, and have transformed the sector into an efficient, sound and strong one. According to joint assessment carried by World Bank and IMF, the conclusion drawn was:

"Reforms have resulted in a more efficient and competitive financial system in particular, the predominantly state-owned banking system has been transformed into one that is predominantly under the control of the private sector. The legislative framework and the State Bank of Pakistan's supervisory capacity have been improved substantially. As a result, the financial sector is sounder and exhibits an increased resilience to shocks."

Pakistan's Banking Sector is one of the highest paying sector of the economy. Despite increasing inflation, compensation for the top executive, in the form of basic salary, bonuses and allowances has increased over the years. The banks in Pakistan have followed an expansionary policy causing the asset base to go up. However, due to lack of business activity and falling interest rates the performance is showing a declining trend.

In Pakistan corporate governance code was implemented in 2002 for listed firms. Presently, corporate governance in Pakistan primarily falls within the ambit of two entities: the SECP and the State Bank of Pakistan. Despite the financial sector being the fastest growing, efficient, strongly regulated with best corporate governance practices, a little work has been done to explore the compensation trends in this sector in Pakistan. In Pakistan research on determinants of CEO compensation is a new area. The studies that have been conducted mostly focused on manufacturing companies (Shah et al, 2009). The objective of this research is thus to identify those factors that affect the CEO compensation specifically in the banking sector of Pakistan.

Theoretical Framework

While Agency Theory predicts a strong association between executive pay and firm performance, the research results from various countries suggest mixed views i.e. the pay-for performance association is either non-existent or, at best, weakly positive (Tosi el al, 2000). Researchers have also shown that in contexts where there is a high level of extraneous market 'noise' and volatility in firm-level performance, the association between CEO pay and firm performance is generally weaker (Conyon and Sadler, 2001; Miller et al., 2002; Mishra et al., 2000). Further, studies based on behavioural versions of Agency Theory, have found boards of the companies to prefer 'subjective' behaviour-based assessment and contracting rather than 'objective' outcome-based contracts (Eisenhardt, 1989; Larraza - Kintana et al., 2007). More

particularly, there is some evidence that the choice between behaviour-based contracts and outcome-based contracts may depend partly whether the board consists chiefly of inside or outside appointees (Caranikas-Walker et al., 2007)

This research focuses on two main theoretical points in traditional Agency Theory and The Managerial Power Theory. Traditional Agency Theory prescribes outcome-based incentives while viewing board composition as non-problematic. Managerial Power focuses on how board composition (i.e. degree of independence) can either encourage or counteract CEO manipulation of outcome-based incentives.

So the question remains does performance affects CEO compensation, do corporate governance mechanism (board structure) affects CEO compensation or do these governance mechanisms affect CEO compensation by acting as moderator between CEO pay and firm-level outcomes (proxy by operating returns)?

Thus we hypothesize that:

H1: Does Corporate Governance mechanism (board size, CEO from family, percentage of independent directors on the board, percentage of shares held by institutional investors and percentage of shares held by the board) affect CEO compensation.(Ozkan, 2011)?.

H2a: Performance act as a mediator to affect CEO Compensation.

H2b: Bank size act as a mediator to justify CEO Compensation. (Hill & Pan, 1991)

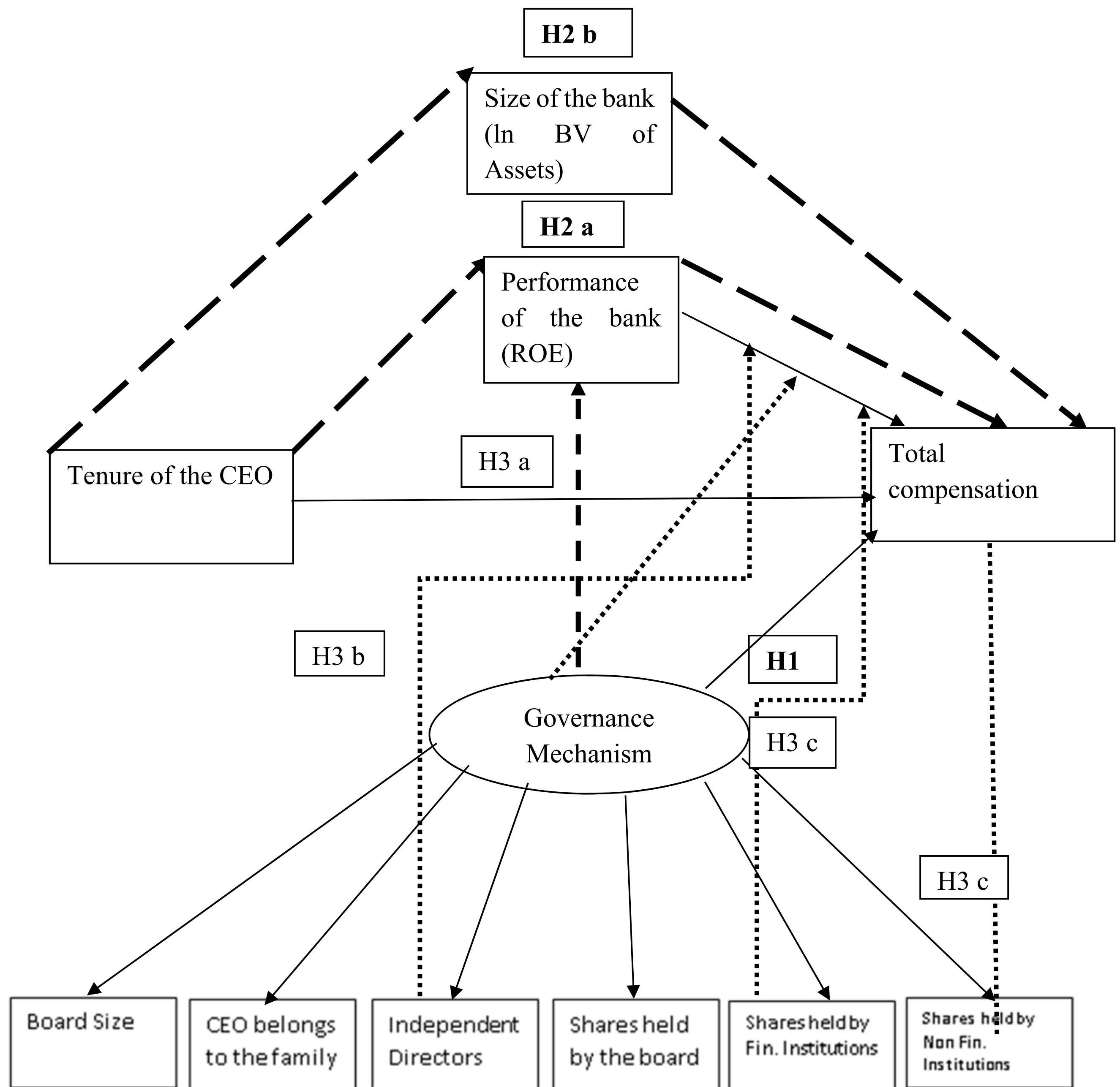
H3a: Governance mechanisms have a moderating impact on the relationship between company's performance and CEO compensation (Vandebeek et al, 2016).

H3b: Independent directors moderates the relationship between CEO compensation and firm's performance. (Wright et al, 2002)

H3c: Institutional directors (shares held by the financial and non-financial institutions) acts as a moderator between CEO compensation and the firm's performance (Wright et al, 2002)

The theoretical framework formulated was shown below:

Figure 1. Theoretical Framework



Where — — line showing the mediation, and

.... Showing the moderation paths in the framework

Methodology

The purpose of this research is to observe differences between compensation of CEO among different banks over the period of 2006 to 2013. This study is a panel data study and follows the descriptive design. Descriptive research is used when the purpose is to describe the characteristics of different groups or to estimate the percentage of subjects in a specified population or to analyse relationships between variables, and also to make predictions (Zikmund, 2003).

The data for this study has been hand collected from published audited annual reports of the 22 banks listed on the Karachi Stock Exchange, for the period 2006-2013. The data has been controlled for year and for the Industry. To get accurate results, a lag of one year is used in the compensation of the CEO, as most of the Pakistani banks decide about the compensation a year ahead. The study includes significant variables, both firm specific and corporate governance specific, identified through the literature.

The dependent variable is CEO compensation. It has been calculated as sum of basic pay, bonus and allowance (Murphy, 1999). In order to include the effect of inflation over the year, log of compensation has been taken. In this paper, the firm specific independent variables included are: performance and size of the company/bank. To gauge the effect of performance on CEO compensation ROE has been used. Since banks in Pakistan shows too much variation in their total asset base, thus ROA is not an appropriate measure of performance. Share price, also, cannot be taken as a measure of performance as stock markets in Pakistan are not driven by fundamentals.

The size of the bank is measured by taking book value of assets. Governance mechanism has been measured as size of the board, the percentage of independent directors on the board, percentage of shares held by institutional investors including percentage of shares held by financial and non- financial institutions, and CEO family. According to Pakistan's Code of Corporate Governance, a CEO cannot be the chairman of the company, thus concept of CEO duality is not applicable in Pakistan. However, as suggested in literature, it is taken in the formation of the governance mechanism in this research paper (*Explanation of the variables have been provided in Table1 Appendix)*

For the analysis, statistical package SPSS 22 and AMOS were used.

Results and Discussion

In order to give insight about Banking Sector in Pakistan, a descriptive analysis was conducted for dependent and independent variables. Total number of values for each variable is 176 (calculated as 22 banks and each bank having eight years data). Total compensation has a mean value of Rs.44620 thousand, it means that the average salary of a CEO in banking sector is Rs 44.62 million per year (i.e. US $0.43 m). However, the basic pay on average is Rs. 27.84 million per year (U.S $ 0.27m). This points out to the amount of fringe benefits CEO's in this sector are enjoying in the form of bonuses(average Rs 5.13 million per year U.S $ 0.05m) and allowances (average Rs 29.87 million i.e. U.S $ 0.29 m in form of provident fund, medical allowance, house rent and utility allowances)

It can also be seen from **Table 1** that average total assets of the banks were Rs 300 million (U.S $ 2.94m), with minimum of Rs 4 million ($ 0.03m) to maximum of Rs 1715.2 million ($ 16.81m). The average performance (ROE) was 10% for the period.

With the help of **Table1**, one can also get a broad picture of corporate governance practices being followed. Banks have 60% of the directors on the board being independent and more than 50% of the shares are held by institutional investors (Shares of financial institutions + Shares held by non-financial institutions). It can also be seen from the table that average tenure of a CEO in the banking sector was 3.2 years, with minimum of 1 year to maximum of 8 years.

Table1: Descriptive Statistics of the Variables (N=176)

Variable	Mean(PKR)	Standard Deviation(PKR)	Min(PKR)	Max(PKR)
Total CEO Compensation	44.26mil	35.62mil	4.02mil	277.52 mil
CEO Basic Pay	27.845m	32.836m	1108	264439
CEO Bonuses	5.130m	10.866m	0	63212
CEO Allowances	29.878m	37.605m	0	277516
Size of Banks (BV of Assets)	299.18mil	316.588	4025	1715271
ROE	10.24%	37.98%	-125.25%	184.06%
Board Size	8.554	1.4167	4	13
Family CEO	0.262	0.44144	0	1
CEO Tenure	3.2 years	2.07 years	1 year	8 years
Independent Directors	58.6%	22.28%	10%	92%
Shares Held by Board	6.68%	11.70%	0%	63.4%
Shares held by Financial Institutions	8.04%	9.5%	0%	46.57%
Shares Held by Non-Financial Institutions	49.2%	30.91%	2%	98.99%

The multivariate technique used in this study is Structural Equation modelling (SEM) using AMOS 22 and maximum likelihood as an estimation technique. The purpose is to identify the relevant variables discussed in literature that play an important role directly, through mediation or moderation in determining CEO compensation, thus SEM appears to be appropriate multivariate technique.

SEM, when applied correctly, has a great edge on the first generation statistical techniques. It is considered as second generation statistical analysis techniques which enables researchers to formulate and analyse complex models which contains a) relationships between numerous predictor and criterion variable, b) ability to construct the latent variables and c) means to find out model errors of measurement. (Chin, 1989).

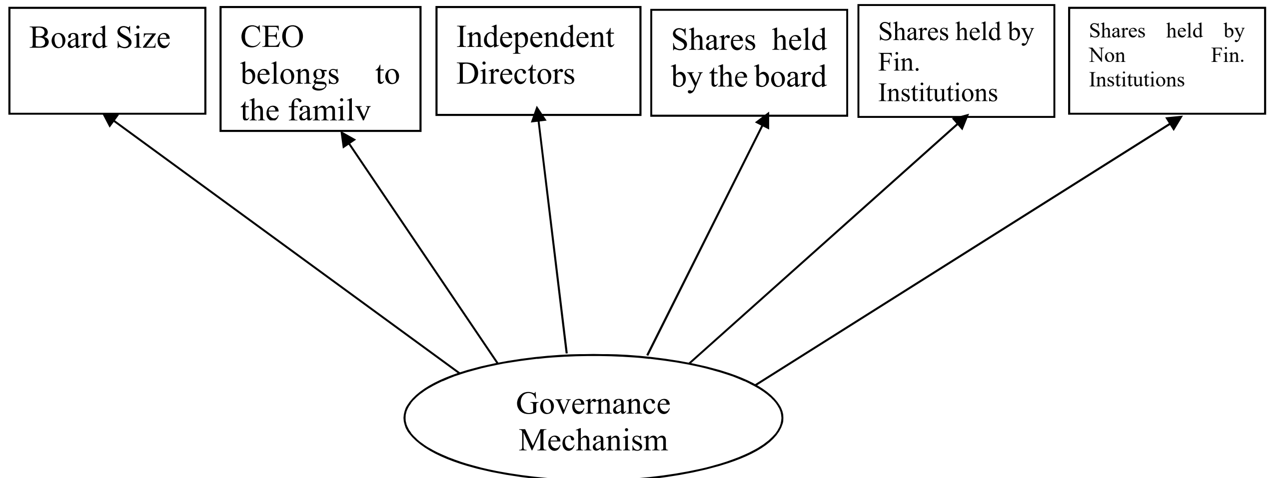
There are two step which can be performed when conducting the SEM analysis. In the initial step, a confirmatory factor analysis is conducted to measure the latent construct. Further its reliability and validity is checked. In the second step path analysis is performed to check the direct and indirect effects. SEM has no single statistical test which can describe the strength of model predicted. Instead, different type of measures, have been developed by researchers to assess the results.

As a first step of SEM, a confirmatory factor analysis (CFA) was performed to measure the latent construct "Governance Mechanism". Further its reliability and validity were also checked.

The Figure 2. shows the latent construct "Governance Mechanism" (GM) with six items. Though, all the variables are positively effecting the GM, only two variables were found to be significantly effecting the Governance Mechanism i.e. shares held by the board and the shares held by the financial and non-financial institutions, at p-value < 0.1, shown in **Table 2**. The standardized regression weights shows more than 100 percent of explanation of latent variable Governance Mechanism by the variable CEO Family (CEO belongs to the family) followed by approximately 40% coming from institutional investors (Shares held by Fin Institutions+ Shares held by Non Fin Institutions).

If we analyse the variable which gives highest explanation or are most significant variables for explaining the latent construct Governance Mechanism we get to know about how governance is being followed within the most regulated sector of the economy. Most of the banks in Pakistan are family owned with one of the family member appointed as the CEO. Thus there seems to be a chance that governance decisions are highly influenced by CEO's in this sector. However, this situation might be beneficial for all stake holders as the family dominant boards have their personal interests and gains attached with the returns of the bank, both in the form of asset (ROA) or equity (ROE).

Figure 2: Governance Mechanism (latent construct)



On the other hand, shares held by the financial institutions came to be significant for the same above mentioned reason. The family or the business group which owns the banks in Pakistan, also have their stakes in other non- depository financial institutions like insurance companies or mutual funds and non-financial institutions like textile or cement companies. Thus majority of the shares held by the board have direct as well as indirect involvement of the family owners, which raises concern about the board independence.

Table 2: Standardized Regression Weights

Variable Paths	Standardized regression weights	P – value
Board Size ← GS	0.09	0.54
CEO of the family ← GS	1.24	0.542
Independent Directors ← GS	0.13	0.165
Shares held by the board ← GS	0.28	0.087*
Shares held by Fin. Institutions ← GS	0.36	0.082*
Shares held by the Non-Fin. Institutions ← GS	0.26	0.14*

*p<0.1

After identifying significant variables for construct "Governance Mechanism" its reliability and validity was checked. Construct reliability of the construct i.e. Governance Mechanism came out to be 0.7 which was found to be within the range (Hair, J.B., 2006). Convergent validity had AVE> 0.5, thus, we can say that the convergent validity also holds. Therefore we can say that the six variable used in CFA analysis, all jointly form one latent construct that was named Governance Mechanism.

The second step in SEM is conducting a path analysis. The direct standardized estimates of the structural model are shown in **Table 3**

As per agency theory, the performance should be the indicator for the firm to increase CEO compensation, which is calculated by adding basic pay, bonuses and allowances. But according to the present research, the hypothesis was rejected at p-value =0.508. The result was in align with previous compensation studies done in Pakistan. (Shah et al, 2009; Athar &Khan, 2012). This means that in Pakistan, the performance is not a significant determinant of CEO compensation.

There can be two explanation for this, firstly, despite ROE being used as a performance criteria in literature, it might not be an appropriate measure for performance when banking business is mostly deposit driven (Wayman.O, McKinsey, 2010). In case of Pakistan, banking business is majorly deposit driven, thus there is a strong chance that ROE appears to be a weak criteria for measuring accounting performance. Secondly, performance becomes a weaker criteria for affecting CEO compensation when CEO's tenure increases. It is argued that long-serving CEOs use firm size and risk as legitimizing variables to justify greater pay (Hill &Pan, 1991). In the current study CEO tenure had a significant positive impact on his compensation, supporting the argument that why performance is not an appropriate criteria for determining CEO compensation in Pakistan.

The basic purpose of this study was to check whether governance mechanism affects CEO compensation. However, the hypothesis was rejected, showing that governance mechanism does not have a significant effect on CEO's compensation. This finding is an eye opener for regulators and practitioners that when industry is dominated by families, and those families appoint CEO within themselves then despite increasing number of independent directors, increasing the size of the board, increasing ownership of institutional investor is not enough to protect shareholder's interest. Governance mechanism fail to reduce agency cost not due to lack of regulation but due to board formation. This finding also raises a concern about the role and independence of external monitors in protecting shareholder's interest.

Table 3: Structural Parameter Estimates

Hypotheses	Hypothesized Path	Standardized Path Coefficients	p-Value	Results
	Performance → Compensation	0.049	0.508	Not Supported
H1	Governance Mechanism → Compensation	-0.128	0.206	Not Supported
	CEO Tenure → Compensation	0.163	0.024*	Supported
Significant at 5%*				

Mediating Role of Performance and Size

In this study, after getting insignificant direct impact of governance mechanism on compensation, its indirect effect was analysed. In AMOS, the mediating role is checked by finding the direct effects and the indirect effects of the path coefficients. If with the inclusion of the mediator, the total effect increases, this means that there is a mediating role of the variable, otherwise, not.

The mediating role of performance was checked with the independent variable i.e. Governance Mechanism.

For H2a, the direct effect from GM to the CEO to compensation was statistically insignificant with $\beta = -0.128$, $p < 0.05$. After the inclusion of Performance (ROE) as a mediator, the β of the direct effect decreased, the indirect effect came out to be $\beta = 0.0001$, making the total effect to be reduced to $\beta = -0.006$. This reduction in the total effect shows that there is no mediating role of performance between GM and compensation, shown in **Table 4.**

Since this study emphasis that most performance measures used in literature might not be appropriate to be used in Pakistan, thus the task was to find other factors that are significant in affecting CEO Compensation. The most important firm specific variable discussed in literature was Firm Size, measured as book value of asset. Study by Lone at al (2016) found firm/bank size and tenure to be a significant variable affecting CEO compensation in Pakistan. Thus, the purpose was to analyse that if Governance mechanism fail to affect CEO compensation directly and indirectly than what justification is used for high CEO compensation. As suggested by Hill &Pan (1991) that some time CEO influence the board as their serving tenure increases and use firm size as a criteria for getting high compensation. For H2 b, the direct effect of tenure on CEO compensation was statistically significant with $\beta = 0.176$, $p < 0.05$. After the inclusion of Size (BV of Assets) as a mediator, the β of the direct effect increased with $\beta = 0.195$, and the indirect effect coming out to be $\beta = 0.074$, making the total effect to increase with $\beta = 0.27$. This increase in the total effect shows that firm size has a mediating role between tenure and compensation, and can be used as justification for increase in CEO compensation over the period of study. The results are shown in Table 4.

Table 4: Mediation Results

Hypotheses	**Relationships**	**Standardized Estimates**			**Results**
		Direct	**Indirect**	**Total**	
H2 a	GM → Compensation	0.121	-	0.121	No Mediation
	GM → compensation (Controlling for Performance)	-0.006	0.0001	-0.006	
	Tenure → Compensation	0.176*	-	0.176*	
	Tenure → compensation (Controlling for Performance)	0.176	-0.009	0.16	
H2 b	Tenure→ Compensation	0.176*	-	0.176*	
	Size → Compensation	0.418*	-	0.418*	
	Tenure → compensation (Controlling for Firm Size)	0.195*	0.075	0.27*	Mediation

The model fit indices for the CFA and path analysis were analysed. Details of the model fits are given in Table 5.

Table 5: Model Fit indices

Indices		**Default Model**
Absolute Fit		
	Chi-Square	44.05(*p= 0.00)*
	Df	22
	CMIN/df	2.002
	RMSEA	0.049
Incremental Fit		
	AGFI	0.913
	TLI	0.926
	NFI	0.895
	IFI	0.967
	CFI	0.964

** p<0.01, * p <0.05

The value of Chi-square along with other fit indices were used to test if the variables fitted the construct. Hatcher (2003) suggested that Chi-square value should be small, whereas its "p" value should be high (between 0.05-1). However, since Chi square value is highly dependent on the sample size, thus chi-square to degrees of freedom ratio between 2 to 5 indicates satisfactory model. On the other hand for values of absolute fit measure (NFI, TLI, CFI, AGFI), should be 0.9 and above. However, RMSEA should be around cut off value of 0.05

The model fit initially produced chi square value of 56.16 with 20 degrees of freedom and p-value < 0.05. The values of absolute fit measure and RMSEA were away from their cut-off values. In order to improve the model fit Modification Indices were used. After using the modification indices, the results obtained are shown in **Table 5**. The values of AGFI, TLI, NFI, IFI, and CFI are all greater than 0.9, which shows the model fit is satisfactory.

Moderating role of the independent directors in the board and shares held by Institution.

In this study, from an agency theory perspective, our main concern is how governance mechanism affect compensation. Since the direct effect of Governance Mechanism was found to be insignificant, our prime contention still is that governance mechanism, especially external monitors may moderate the relationship between managerial rewards and company's returns. We focused on three groups of external monitors in the development of our hypotheses. They are independent outside board members, institutional investors and non -financial institutional investors.

The H3a was a complex relationship as the direct paths both(GM to CEO Compensation and Performance to Compensation) were insignificant but the interaction term of the governance mechanism and the performance was found to be significant, thus we can say that there is a moderating effect of the governance mechanism on the performance to compensation relationship.

According to the literature, independent directors should have a positive and significant role in effecting both the performance of the firm and the CEO's compensation. Independent directors, being in no relation with the family owning the business and having no stakes in the firm should act as a filter in the decision making done by the board. Hence, effecting the performance

Later in H3 b and c the moderating role of external monitors was checked. The direct paths for Independent directors and compensation of the CEO was insignificant with $\beta = -0.104$, $p = 0.167$ and for performance and compensation was already found to be insignificant in H1. The interaction between independent directors and performance also came out to be insignificant. Hence H5b was not supported. The results are shown in **Table 6**.

In H3c the moderating role of institutional investors was checked. It included shares held by the financial institutions (SFI) and non-financial institutions (NFI). The direct path of the shared held by financial institution was found to be highly significant with $p<0.001$, the direct path of the performance and compensation was insignificant but the interaction of performance and shares held by the financial institution was found to be significant with $\beta = 0.192$, p =0.0.42 of the interaction term. Thus supporting the hypothesis that financial institutions play a moderating role by looking at performance to decide CEO compensation.

On the other hand the direct path of the shared held by non- financial institution was found to be insignificant with $p<0.001$, the direct path of the performance and compensation was insignificant, but the interaction of performance and shares held by the non - financial institution was also found to be insignificant with $\beta = 0.095$, $p = 0.26$ of the interaction term. Thus rejecting the hypothesis that non-financial institutions moderate the pay to performance relationship.

Table 6: Moderation Results

Hypotheses	Hypothesized Paths	Standardized Path Coefficients	p-Value	Results
H3 a	Governance Mechanism → Compensation	-0128	0.206	Supported
	Performance → Compensation	0.049	0.508	
	Performance * Governance Mechanism → Compensation	0.179	0.002	
H3 b	Independent Directors → Compensation	-0.104	0.167	Not Supported
	Performance → Compensation	0.088	0.24	
	Performance * Independent Directors → Compensation	-0.054	0.469	
H3 c	% of Shares held by FI (SFI) → Compensation	-0.285	0.005**	Supported
	Performance → Compensation	-0.04	0.585	
	Performance * SFI → Compensation	0.192	0.049*	
H3 c	Shares held by the Non-Financial Institutions(NFI) → Compensation	0.097	0.195	Not Supported
	Performance → Compensation	-0.04	0.59	
	Performance * Shares held by NFI → Compensation	0.095	0.206	

Conclusion:

This study is an extension of the work done by Lone et al (2016) and takes one step forward to test the argument given in agency theory i.e. there is a strong association between managerial compensation and firm performances and governance mechanism play an important role in reducing the agency cost. In the previous study by Lone et al (2016) performance was found to have insignificant direct impact on CEO compensation. The focus of the current research was to check whether governance mechanism directly affect CEO compensation or has a moderating role in pay to perforce relationship. Moreover, this study aims to explore that if performance does not affect compensation directly than does performance have an indirect/mediating effect on CEO compensation. The results suggest that:

1. Performance does not have significant direct nor indirect effect on CEO compensation.
2. Size of the firm has a significant and positive direct and indirect impact on CEO compensation in the banking sector of Pakistan. The most interesting finding was that how CEO's use bank size as a criteria to justify high pay packages, especially when the service duration of the CEO increases.

The study also identified what variables define governance mechanism in the most regulated sector of the economy and does governance mechanism affects CEO's compensation. The results suggested that:

3. The most dominant variable in the governance mechanism for Banking Sector in Pakistan was having a CEO appointed from the family who also owns the bank. External monitors in

form of financial and non-financial intuitions were also found to have a significant role in determining governance mechanism in Banking Sector of Pakistan.
4. Independent directors were found to have less explanatory power and non-significant impact in defining governance mechanism in the banking sector.
5. Governance mechanisms were found to have insignificant direct impact on CEO compensation. However, governance mechanisms protected shareholders interest by acting as a moderator between pay to performance relationship
6. Lastly, the study tested the moderating role of external monitors on CEO compensation and performance relationship. The study included independent directors, financial institutions and non-financial institutions as external monitors. Only financial institutions were found to have significant moderating role on pay to performance relationship.
The gap identified from this research work was that traditional performance measure like ROE may not be applicable for banks, especially when the banking industry in the country is majorly deposit driven. Thus future research should focus on developing an objective criteria for accounting performance. Also the findings supported the argument given in literature that more importance should be given to board structure and board performance. Having minimum independent directors or bringing institutional investors on the board does not necessarily mean that good governance is being implemented in its true sense and agency costs are being reduced. In governance literature, a gap still exists that does not cater demographic features of the CEO with firm specific and governance variables to understand top manager's compensation. Unfortunately, in case of Pakistan there is no other source, except the annual reports, to find about the corporate governance practices. The level of disclosure in these report lacks the information about the demographics of the CEO, especially age, qualification and experience. (80 % missing values generated). Including such variables, and making disclosure in more detail can better capture the true impact of factor that can affect CEO compensation.

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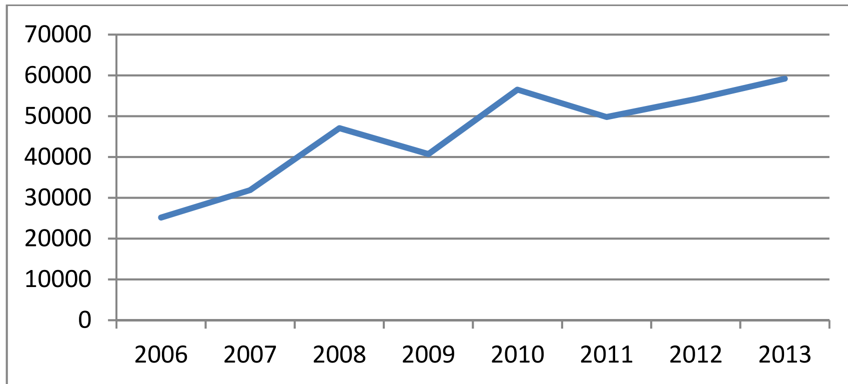
Appendices:

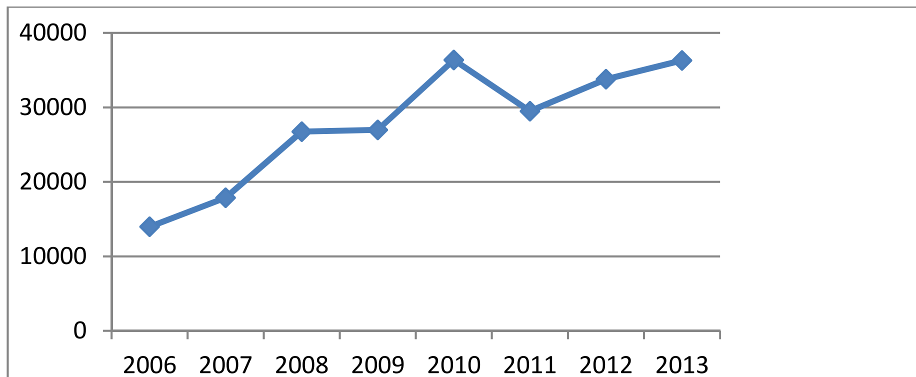
Appendix 1: Variable Description

Variables	Definition/Description
Dependent Variable	
Ln Comp	CEO compensation calculated as sum of salary, bonus and allowance (Stock options concept is not applicable in Pakistan
Independent Variables	
ROE	Profit Before Tax/Share Holder Equity
Firm Size	Book Value of Assets
Ownership Structure	
Board Size	No of directors on the board
CEO family	Equals 1 if CEO is the member of the controlled family
CEO Duality	Equals 1 if CEO is also the Chairman of the Company
Independent Directors(IndpDir)	% of independent directors on the board
Share of Financial Institutions(ShareFI)	% of shares held by Financial Institutions
Share of Non- Financial Institution(ShareNFI)	% of shares held by Non-Financial Institution
Shares held by the board(Share Board)	% of shares held by the board

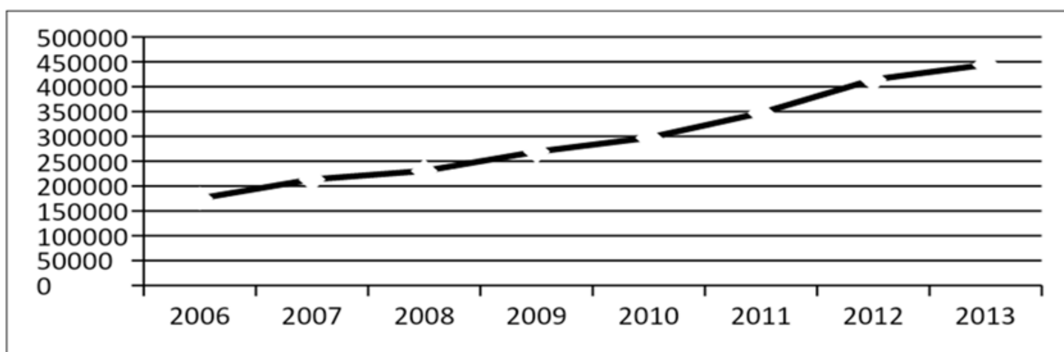
Appendix 2:
Trend of Average Total Compensation



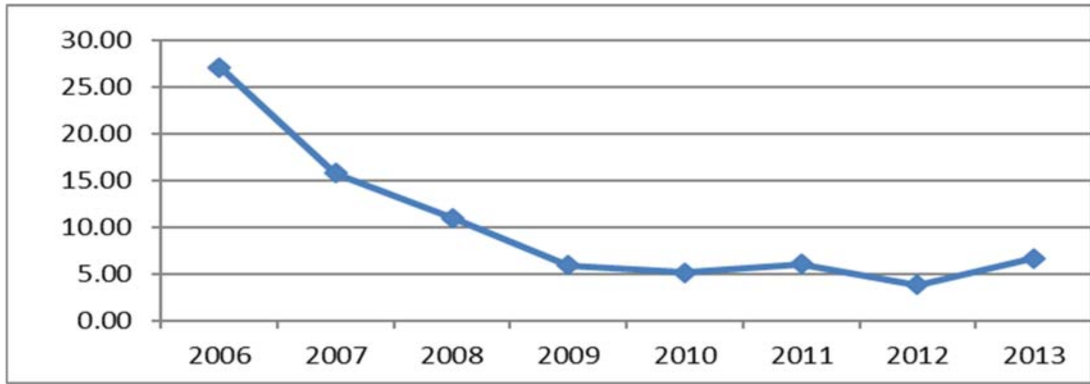
Trend Average Basic Pay



Average Bank Size



Performance Trend (ROE)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