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Examining Causality Of Managerial Ability Against Executive Compensation (Case Study on Conventional Banking in Indonesia)

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ABSTRACT

Executive compensation can be a reducer of agency conflict between managers and shareholders, therefore this study seeks to examine the variables that affect executive compensation, especially the managerial ability variable. This research is causality research. The population is all conventional banks listed on the Indonesia Stock Exchange from 2017 to 2021. The sample was taken using the Purposive Sampling technique and found 32 banks that match the specified characteristics. Panel Data Regression was used to analyze the data using the Eviews 9 program. Managerial ability has been shown to have a positive effect on executive compensation in banking in Indonesia during the study period. Managers who have higher abilities will make the company perform well, therefore managers who have higher abilities should be given greater compensation.

Keywords: Managerial Ability, Executive Compensation, Conventional Banking.

1. Introduction

1.1 Background

Jensen and Meckling, (1976) created agency theory which continues to be used today. The theory states that the existence of an agency relationship between managers and shareholders, managers and creditors or between shareholders can lead to various agency conflicts. Agency conflicts between shareholders and managers that often occur are related to salaries and other forms of compensation provided to executives by the company. Shareholder dissatisfaction will occur if the company pays high salaries to executives but the shareholders receive unsatisfactory returns for their investments.

Sirkin and Cagney (2016) define executive compensation as the package received by senior executives and all matters related to it. Milkovick and Newman (2008) mention things that include executive compensation, namely salaries, bonuses; incentives and capital appraisal plans, executive benefits, and executive perquicites. Sutapa and Saputra (2006) explain that executive compensation is a form of incentive or reward given by company owners (investors) to directors in generating profits.

The issue of executive compensation is also interesting to study because there are many studies that prove that executive compensation is very influential on company performance (Putra and Supatra (2012), Sari and Harto (2014), Rehobot (2012), Anisa (2014), Widamunti (2010) , Parimana and Wisadha (2015. Chou and Buchdadi (2016) found evidence of the effect of executive compensation on company performance. Therefore, it is necessary to study the variables that play an important role in determining executive compensation.

Previous researchers are Brown & Caylor (2004); Ruge (2005); Partasarty et al., (2006) and Iqbal et al., (2010) proved that company performance as proxied by ROA, NPM, and EPS has a positive effect on executive compensation. High company performance is produced by managers who have high abilities. Hambrick and Mason (1984) who discovered the upper echelons theory explained that the complexity of the actual decision-making situation requires the special ability of the top management team. Manager style influences managers' decisions in carrying out activities such as R & D, mergers and acquisitions. This was conveyed by Bertrand and Schoar (2003). Economically, managerial ability is important in influencing company performance (Leverty and Grace, 2012).

Given the importance of the role of managers, it is appropriate that managers who have high abilities will get high compensation as well. Chou and Buchdadi (2018) conducted a study of the effect of executive compensation on firm performance with firm size as a control variable. As a result, there are significant results between the effect of compensation on company performance.

Considering that executive compensation is very influential on company performance and executive compensation problems are prone to causing agency conflicts, it is important to continue research on executive compensation. In addition, in contrast to developed countries, research on executive compensation in developing countries such as Indonesia is still very little done. This is because disclosing salary in Indonesia is considered taboo or something inappropriate to do. The existence of previous researchers who found evidence that managerial ability has a positive effect on executive compensation (Murphy, 1985; Morse et al., 2011; Baranchuk et al., 2011 and Graham et al., 2012) spurred researchers to prove this situation in Indonesia.

1.2 Research Objectives

This study only aims to analyze the effect of managerial ability on executive compensation in banking in Indonesia.

2. Literature Review

2.1 Upper Echelon Theory

Upper echelon theory is the theory put forward by Hambrik and Mason in 1984 which considers the concept of top management as the main strategic decision maker in the organization. Thus, strategic decisions made by leaders have an exclusive impact on what will happen to the organization. This is because the executive has responsibility for the organization as a whole. Their characteristics, what they do, and how they do it, specifically affect organizational outcomes. Hambrick and Mason (1984) state that the company's strategic decisions are strongly influenced by the characteristics of upper echelon managers who make decisions and the company's strategic performance. Upper echelon theory reveals that the results of an organization are a reflection of the top managers/upper echelons. This theory further states that the characteristics of top managers affect one of them in risk taking which in turn affects the company's performance (Hiebl, 2013).

In the last few decades, research on top managers of organizations has shown a very rapid increase. Wang et al. (2015) conducted a research by collecting articles related to upper echelon theory for the last 3 decades. The results of his research show that CEO traits have a significant influence on the company's strategic actions and the company's future performance. According to Zein, (2016) leaders play a crucial role in making strategic decisions and resource allocation. While in Toyyibah, (2012) suggests that the upper echelon theory provides some basics about the importance of studying the characteristics of the Commissioners and Directors, because the company's performance is a reflection of top management, thus studying the characteristics of management is very crucial because it will determine the company's performance where one of them will have an impact on corporate profits.

2.2 Agency Theory

The existence of separation between ownership (principal), namely shareholders and control (agent) is the core of agency theory. Companies that separate the management function and the ownership function will create differences in interests between executives and shareholders. The separation between the owner of the company (principal) and management by management (agent) tends to create an agency conflict between the principal and the agent. agency costs arise as a result of a conflict of interest between the owner and management caused by the agent not acting in accordance with the wishes of the principal. Agency costs are costs incurred by the principal to supervise agents, expenses that bind agents, so that they work for the benefit of the company. Jensen & Meckling, (1976), explained that including agency costs, namely Monitoring costs, Bonding costs and Residual loss.

2.3 Executive Compensation

Sirkin and Cagney (2016) explain that executive compensation in a simple sense is the package received by senior executives and all the issues related to it. The components of executive compensation according to Milkovich and Newman (2008) consist of salaries, bonuses, long-term incentives and capital appraisal plans, executive benefits and executive benefits (Dessler, 1998:45). Factors that affect management compensation consist of six factors, namely: government factors, joint supply between companies and employees, standard and cost of living of employees, size of wage comparison, demand and supply, and ability to pay (Dessler, 1998:45).

Mathis & Jackson, (2002) explain that compensation programs in organizations must have four objectives, namely: a) Fulfillment of the legal side, with all appropriate regulations and laws; b) cost effectiveness for the organization; c) individual, internal, external balance for all employees; and d) increasing the success of organizational performance.

2.4 Managerial Ability

Managerial ability is the manager's expertise in mastering technology and industrial conditions, conducting more profitable investment activities, being able to forecast product sales, and being more efficient in managing employees. A capable manager will be better able to generate higher income at a certain level of resources or vice versa can minimize the use of resources at a certain income level (Demerjian et al., 2012).

Demerjian et al., (2012) used a different measure of managerial ability from that used by previous researchers. Fee and Hadlock (2003) use prior industry-adjusted stock returns as a proxy for managerial ability. Milbourn (2003) uses a proxy for managerial ability with higher compensation

for performance, CEO tenure, prior media mention, outside appointments, and prior industry-adjusted stock returns. Rajgopal et al (2006) measured talent by the CEO's financial press visibility (using prior media mentions) and the firm's prior industry-adjusted return on assets and showed that outside employment opportunities increased with managerial talent.

Demerjian et al., (2012) used the residuals from the results of Tobit Regression between variables which are characteristics that are considered specific to the company and outside the manager's influence on the company's efficiency value. The value of the company's efficiency is calculated using Data Envelope Analysis. Demerjian et al., (2012) measure the success of the company by using income efficiency. The value of income efficiency that has been cleared from the influence of variables which are characteristics that are considered special in the company and outside the influence of managers is the managerial ability score. The results of Demerjian et al., (2012) are then used as a reference by Andreou et al., (2016) to calculate managerial abilities in the banking industry. In contrast to Demerjian et al., (2012) who use income efficiency as a performance proxy, Andreou et al., (2016) use earnings efficiency as a measure of company performance. Efficiency calculation is done using Stochastic Frontier Analysis (SFA). This is done with consideration because profit is the main motivation for managers and bank owners.

2.5 Hypothesis Development

Management literature and previous researchers have long emphasized the importance of the role of managers in determining the success of the company. Through the upper echelons theory, Hambrick and Mason (1984) and Hambrick (2007) explain the role of management factors in driving the company's success. In addition, a group of researchers, namely Bamber et al., (2010), Ge et al., (2011), Beatty and Liao (2011), and Leverty and Grace (2012) proved the role of management ability. in influencing company performance. Thus, high managerial ability will cause the company to perform higher, if the company's performance is higher then the company's income is more, the company's income is more so it can compensate executives with more. Therefore, the proposed hypothesis is "managerial ability has a positive effect on executive compensation". Thus, more talented managers will be given greater compensation

3. Research Methodology

3.1 Research Methods

This type of research is causality research with exogenous variable of managerial ability and endogenous variable is executive compensation. Conventional Commercial Banks in Indonesia listed on the Indonesia Stock Exchange during the 2017-2021 period are the population in this study. Sampling was done by purposive sampling. The research variables consist of executive compensation variable and managerial ability variable. The variables used in this study are:

- Executive Compensation
  The calculation of executive compensation is in accordance with the provisions of the Financial Services Authority of the Republic of Indonesia No. 45/POJK.03/2015, namely by adding up the total compensation/remuneration received by the board of commissioners and directors of each company which is reported in the company's annual report, both in cash and in cash. The result of the executive compensation calculation unit is in millions of rupiah. The result of the executive compensation calculation unit is in millions of rupiah.
- Managerial Ability
  The steps in calculating the efficiency value and managerial ability score are as follows:

- Collect data for Input Price Variables. The data consists of data P1 (Price of funds), P2 (Price of labor) and P3 (Price of physical capital) (Srairi, 2009).
- Collecting data for Output Price Variables consisting of total loans and other productive assets other than credit)
- The value of bank efficiency is calculated using Data Envelopment Analysis (DEA) which is input-oriented using input and output data contained in point a in accordance with research from (Dermerjian, 2013).
- Calculating the Managerial Ability Score by regressing the efficiency value obtained from the DEA calculation with bank characteristics, namely: BSize (log of total gross assets), NEmp (log of number of employees), Age (log of bank age (in years), LevRag representing leverage (total debt divided by total assets. Managerial Ability Score is the residual of total bank efficiency after eliminating a number of bank-specific characteristics that affect bank efficiency using Tobit regression

$$MAt = \alpha + \beta 1\ lnSizei,t + \beta 2\ Agei,t + \beta 3\ Nempi,t\ \beta 4\ LevRagi,t + \in i,t$$

Information :
MAt = managerial ability
lnSize = natural logarithm of total gross assets
Age = company age (years)
Nemp = number of employees
LevRag = lavarage
i = 1, 2, ..., i
t = range of years

3.2 Analysis Method

- The first data analysis activity is carried out by describing the data that has been collected (Sugiyono, 2013: 147).
- Data Envelopment Analysis (DEA) is used to measure the company's efficiency level by following the calculation method performed by (Dermerjian, 2013).
- To find the residual value of the regression between Lnbsize, Lnage, LnNemp, LnLavrage on bank efficiency calculated using DEA, Tobit Regression Analysis is used. The reason for using Tobit Regression is because the bank efficiency value is limited and only ranges from 0 to 1.
- Panel Data Regression Analysis is used to test the hypothesis. Panel data analysis calculations are carried out using the Eviews 9 program.
- Classical Assumption Test, Verbeek (2008), Gujarati (2012), Wibisono (2005), Aulia (2004) in the book Ajija et al (2011) mention the advantages of panel data that do not require classical assumption testing. This is due to the advantages of panel data, namely minimal bias that arises in the analysis, providing more information, variations, and degrees of freedom (Gujarati, 2012). Panel data can also detect and measure impacts better which cannot be done if the analysis uses cross section and time series methods.

4. Results

4.1 Efficiency

The efficiency value is needed to calculate the residual from the regression results between the fixed variables that affect the company's performance beyond the control of the manager to determine the score of managerial ability. The data used to calculate efficiency comes from the 2017 to 2021 financial statements. Data Envelopment Analysis (DEA) is an analytical tool used to determine the level of efficiency in this study by comparing the company's output and input. Efficiency results are defined by a value of 1 which means efficient, while the further away from the value 1 the more inefficient the bank (Demerjian, 2013).

The results of the analysis show that the efficiency value of conventional banking in Indonesia ranges from 0.32 to 1.00. The average value of efficiency of conventional banking in Indonesia is 0.87. Based on the results of the analysis, it is known that from as many as 175 observations, there are 163 banks that are efficient because they have an efficiency value of more than 0.6 (Frantz, 2020) and there are 12 banks that are inefficient because they have an efficiency value of less than 0.6. Thus, it is proven that 94.29% of conventional banks in Indonesia are efficient.

4.2 Managerial Ability

Managerial ability is an exogenous variable in this study. The data used comes from efficiency scores which are then regressed with Tobit regression because the variables used are not independent or censored. According to Tobin (1958) bank efficiency data is censored data, limited and may only range from 0 to 1. The variables used are efficiency scores, Lnbsize, Lnage, LnNemp, LnLavrage. Tobit regression results are then made an estimation model whose results are known by finding the residual value, namely Yi - Ypredict. The residual value becomes a managerial ability score that will be used as an exogenous variable.

The results of the analysis show that the residual value which is a managerial ability score ranges from 0.000000 to 0.480000 with an average of 0.109625. The lowest level of bank managerial ability is Bank CIMB Niaga Tbk and the highest is Bank Jago Tbk. The score of managerial ability shows that the higher the score of managerial ability, the higher the managerial ability of the company.

4.3 Executive Compensation

This study uses executive compensation as an endogenous variable. The value of executive compensation is the total compensation/remuneration received by the commissioners and directors of each company, both in cash and in cash. The results of the analysis show that the value of executive compensation in banking in Indonesia during the study period ranged from 2,056 to 516,403 with an average of 281,243.07 (in millions of rupiah) per year. The company with the highest level of executive compensation was Bank Central Asia Tbk in 2018 while the company with the lowest level of executive compensation was Bank Negara Indonesia Tbk.

4.4 Data Analysis

- Panel Data Regression Estimation Model
  The panel data regression model has 3 estimation models, namely common effect, fixed effect and random effect. The first step in analyzing is choosing the best model from the 3 estimates using statistical methods as well, namely the Chow, Hausman and Lagrange Multiplier tests.

Hypothesis testing is carried out to test the hypothesis that has been built, namely managerial ability has a positive effect on executive compensation with 3 estimates, namely common, fixed and random effect models.

The first stage of the analysis is carried out by regressing the managerial ability variable to executive compensation using 3 estimation models, namely common, fixed and random effect models. Table 1 shows the output results of the test of the effect of managerial ability on executive compensation for the common effect model.

Table 1. output of managerial ability regression on executive compensation (common effect model)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.088800	0.001369	64.88190	0.0000
KM	0.051598	0.009682	5.329154	0.0000
R-squared		0.152360	Mean dependent var	0.094456
Adjusted R-squared		0.146995	S.D. dependent var	0.011834
F-statistic		28.39988	Durbin-Watson stat	0.235643
Prob(F-statistic)		0.000000		

Table 1 is used to form the following regression equation:
KEit = 0.088800 + 0.051598KMit + e

- The constant of 0.088800 indicates that if the managerial ability variable is zero, then the executive compensation variable will be worth 0.051598
- The regression coefficient of managerial ability of 0.051598 indicates that if there is an increase in the managerial ability variable by one unit, it is predicted that the executive compensation variable will increase by 0.051598.

The value of the adjusted coefficient of determination for the regression equation with the common effect model is 0.146995. This means that managerial ability affects executive compensation only by 0.1470 percent. Therefore, 85.30 percent is influenced by variables that are not examined.

Furthermore, the regression of the influence of managerial ability on executive compensation is carried out with a fixed effect model. In the fixed effect model, it is considered that there are differences in intercepts between cross sections which are estimated using a dummy variable. Table 2 shows the output for the fixed effect model.

Table 2. Output of managerial ability regression on executive compensation (fixed effect model)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.093844	0.000256	366.2048	0.0000
KM	0.005582	0.002158	2.586882	0.0108
Effects Specification				
Cross-section fixed (dummy variables)				
Weighted Statistics				
R-squared		0.991021	Mean dependent var	0.211526
Adjusted R-squared		0.988759	S.D. dependent var	0.148980
F-statistic		438.0394	Durbin-Watson stat	1.640366

Prob(F-statistic)	0.000000		
Unweighted Statistics			
R-squared	0.919040	Mean dependent var	0.094456
Sum squared residu	0.001803	Durbin-Watson stat	1.137747

Selanjutnya dilakukan regresi pengaruh kemampuan manajerial terhadap kemampuan eksekutif dengan model random effect. Pada model random effect diasumsikan bahwa perbedaan intersep antar cross section atau timeseries diakomodir oleh error dari masing-masing observasi. Tabel 3 menunjukkan output untuk model random effect.

Table 3. Output of managerial ability regression on executive compensation (random effect model)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.093252	0.001774	52.57989	0.0000
KM	0.010986	0.004368	2.514990	0.0129
Effects Specification			*S.D.*	*Rho*
Cross-section fixed (dummy variables)			0.009513	0.8649
Idiosyncratic random			0.003760	0.1351
Weighted Statistics				
R-squared	0.036210	Mean dependent var		0.016441
Adjusted R-squared	0.030110	S.D. dependent var		0.003941
F-statistic	5.936172	Durbin-Watson stat		0.862001
Prob(F-statistic)	0.015944			
Unweighted Statistics				
R-squared	0.057971	Mean dependent var		0.094456
Sum squared residu	0.020975	Durbin-Watson stat		0.097808

After estimation with 3 approach models, then determine the best model among the 3 estimates. First, the Chow test was conducted to determine the best model between the fixed effect and the common effect. Second, the Hausman test is carried out to determine the best model between fixed effects and random effects, if the two tests provide inconsistent model selection, then proceed with the Lagrange multiplier test to determine the best model between common effects and random effects. However, if the Chow and Hausman tests give consistent results, it is sufficient to test the determination of the best model on these two tests and no Lagrange multiplier test is needed.

The criteria for determining the Chow test is to look at the probability value of the cross section F. If the probability value is less than 0.05 then the best model is the fixed effect, and if the probability is greater than 0.05 then the best model is the common effect. Table 4 shows the output of the Chow test to determine the best model between the fixed effect and the common effect.

Tabel 4. Hasil Uji Chow Persamaan Regresi Data Panel

Effects Test	Statistic	d.f.	Prob.
Cross-section F	336.074168	(31,127)	0.0000

Table 4 shows the results of the chow test which explains that the prob value is 0.0000, so the according to the chow test the best model is the fixed effect. Table 5 shows the output of the Hausman test to determine the best model between random effects and fixed effects.

Tabel. 5. Hasil Uji Hausman Untuk Persamaan Regresi Data Panel.

Test Summary	Chi-Sq. Statistic	d.f.	Prob.
Cross-section random	11.353955	1	0.0008

Table 5 shows the probability value of a random cross section is 0.0008. This means that according to the Hausman test the best model is the fixed effect. The results of the analysis show that the Chow and Hausman tests give consistent conclusions, therefore there is no need to do the Lagrange multiplier test.

After determining the best model, it is known that the best model to test the hypothesis is the fixed effect model (Table 2). Based on table 2, the following regression equation can be formed: KEit = 0.093844 + 0.005582KMit + e

- The constant of 0.093844 indicates that if the managerial ability variable is zero, then the executive compensation variable will be worth 0.093844
- The managerial ability regression coefficient of 0.005582 indicates that if there is an increase in the managerial ability variable by one unit, it is predicted to increase the executive compensation variable by 0.005582.

From table 2 it is also known that the significance value of the managerial ability variable is 0.0108 less than = 0.05. This means that managerial ability has a positive effect on executive compensation, so the hypothesis is accepted. The Adjusted R-Square value of 0.9888 means that managerial ability to influence executive compensation is 98.88 percent, while 2.12 percent is influenced by other variables not examined.

5. Discussion

Managerial ability has been shown to affect executive compensation by 98.88 percent, thus it can be said to be very dominant. This is in line with the results of previous researchers who found evidence that more talented managers will be given greater power and can contribute more to company performance than managers. less talented managers. Therefore, more capable managers will be given greater compensation. The important role of managers in influencing company performance has been widely proven by previous researchers (Bertrand and Schoar (2003), Hambrick (2007 and Leverty and Grace (2012)).Given the importance of the manager's role, managers who are more capable deserve to be given greater compensation. .

6. Conclusion

The results of the study prove that managerial ability has a positive effect on executive compensation. Higher managerial abilities will make managers smarter in making good investment decisions so that they can increase company income. Therefore, managers who have higher managerial abilities are entitled to greater compensation.

- Implication
  The results of this study prove that managerial ability greatly affects executive compensation, therefore companies should provide appropriate compensation to managers who have high abilities. Adequate compensation will be able to spur managers to be more

motivated to improve company performance in order to increase company value and the welfare of company owners.

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