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EFFECT OF CHIEF EXECUTIVE OFFICER OVER CONFIDENCE ON DIVIDEND POLICY OF COMMERCIAL BANKS IN KENYA

** Dr. Ogilo Fredrick, ** Arwa Ahmed Hassan

*Lecturer, School of Business, University of Nairobi, ** MBA student, University of Nairobi

Abstract

This study sought to establish the effect of CEO overconfidence on dividend policy of commercial banks in Kenya. The study used descriptive research design. The study used primary and secondary data. Regression and correlation analysis were used to establish the effect of CEO overconfidence bias on dividend policy. The study found out that; size had a positive effect on dividend policy which was statistically significant while liquidity had a negative effect on dividend policy and was not statistically significant. The coefficient of determination for the regression was found to be 31%. This indicated that, the independent variable explained only 31% of the variation in the dependent variable. The study concluded that, CEO overconfidence bias is a costly affair for commercial banks since it has a negative effect on dividend policy. It also concluded that, size had a positive effect on dividend policy while liquidity had a negative effect. This study recommends that, banks should monitor on the rate of CEOs overconfidence because overconfidence bias appears to affect the dividend policy negatively. Further, future research could be carried on the effects of CEO overconfidence bias on the dividend policy on financial institutions or may assess the effect of behavioral bias on dividend policy of commercial banks.

Key Words: CEO overconfidence, Dividend Policy, Commercial banks

1.0 Introduction

Overconfidence occurs when the relationship between confidence and accuracy is misaligned such that confidence becomes higher than it should be (Meyer et al., 2013). Overconfidence can be used to refer to excessive certainty or to positive illusions. The former is the tendency to have positive illusions on our merits relative to others. The previous one describes the tendency we have to believe that our knowledge is more certain that it really is (Galloway, 2015). Overconfidence in an individual's own assessment can result from people's likelihood distributions tending to be too tight (Lichtenstein et al., 1982). Overconfidence is a term broadly used since 1960s in psychology and researchers from different fields especially finance and economics had extended their meaning to mean a wider scope that the standard scope doesn't explain (Skata, 2008). Malmendier (2008) and Tate (2005) classified CEO's who excessively invest individual funds in businesses they own as being 'over-confident'. The term 'dividend policy' refers to the process that is followed by management in making decisions regarding dividend payout or the pattern and size of distribution of cash to shareholders (Lease et al., 2000).

Razek (2011) described overconfidence as an over approximation of the probabilities for a group of occurence. Agrawal (2012) concluded that overconfidence makes people to overestimate their ability to control events, undervalue risks and overestimate their knowledge. Heaton (2002) cites the psychological research (Weinstein 1980, March and Shapira 1987) that backed the opinion that people are generally overconfident. De Bondt and Thaler (1995) state that the main conclusion in the psychology of decision is that people are overconfident. People regularly see themselves as having greater ability and control over events than it is necessary (Taylor & Brown, 1988; Langer & Roth, 1975). This inflated sense of ability and control causes them to predict that the future is brighter and more certain than, it is in normal.

Agrawal (2012) noted that overconfidence affects the behavior of both investors of the primary and secondary market. Hsu & Shiu (2010) studied the investment returns of investors in discriminatory auctions in the Taiwan stock market and found that infrequent bidders over-performed frequent bidders. Sewell (2005) warned that overconfidence is mainly seductive when investors have special information or experience- regardless of its insignificance - that encourages them to consider that they have an investment advantage. Kahnemann and Lovallo (1993) contended that managers might at times make either courageous predictions or timid choices about a potential project due to overconfidence or risk aversion respectively. Thus in tournament model by Goel and Thakor (2000) to promote managers to executive positions, managers grew to be over-confident so as to extend their odds of success. It is thus helpful for the wealth of shareholders, as it balances portion of manager's avoidance of risk. Gervais et al. (2002) in examination of whether over-confidence of managers can counterbalance/offset sub optimal risks taking decision in capital structure because of manager's avoidance of risk, found that overconfidence exacerbate the problem.

According to Lease et al. (2000), the phrase ‘dividend policy’ refers to the management practice followed in creating dividend payout decisions, or in other terms, is the distribution of cash to shareholders over a period in terms of pattern and size. It is an essential policy to corporations about which other financial policies revolve (Alii et al. 1993). Allocation decision of dividend or revenue is among the 4 decision areas in finance. Nissim & Ziv (2001) defined dividend policy as the regulations and guidelines which a firm uses to make dividend payment decisions to stakeholders. The main component of firms is the dividend policy decisions.

Decisions on dividends are significant as they decide on funds that are either to go to investors and those that the firm is to retain for investments (Ross et al. 2002). Moreover, it also gives shareholders on information regarding the firms’ performance. According to Foong et al. (2007), both potential dividends and earnings of the future and manipulation of cost of capital are determined by the company’s investment. Thus the continued existence of corporations is reliant on investment infacilities that are continuous, usage of internal financing, by using retained earnings from essential segments of financial source to base the investment needs (Bajaj & Vijh 1990; Osaze & Anao, 1990). For shareholders the important aspect to them is dividend that is in return of the investment they carry and risks they may face, therefore these are determined by various aspects in an organization. Mainly, the factors include; investment choices and chances, firm size, financing limitations, regulatory regimes and pressure from shareholders. However, the dividend payout of firm’s offers information relating to firm’s current and future performance as it is also the source of cash flow to the shareholders.

1.1 Research Problem

Zhao and Ziebart (2017) carried a study on consequences of CEO’s overconfidence and found that market markdowns over confidences in CEO by raising the borrowing cost and financial market as well integrates previous CEO overconfidence into bond pricing. Han, Lai and Ho (2015) established that overconfidence in CEO had a positive effect on the performance of the firm, entailing that CEOs overconfidence reaches shareholders expectations through higher returns, less risk and higher profitability. Banerjee et al.’s (2015) found that self-governing board alleviates the CEO overconfidence costs in terms of risk exposure and investment.

Sanjay Deshmukh, A., Goel, B. & Keith, M.(2013) established the dynamic relationship between the overconfidence in CEO’s and dividend policy, they argued that there exists a positive market reaction when dividends is higher. Schrand and Zechman (2011) also found out that managers that are overconfident tend to underestimate risks, and thus setting up high dividend policy at the cost of investments and reserves. Azouzi and Jarboui (2012) reinforced this argument in their research in Tunisia of 100 companies, which showed that CEO’s overconfidence positively effects dividend policy. On the other hand, Malmendier and Tate (2015) argue that management overconfidence correlates with the decision to pay lower dividends. Another study by

Mohammadinasab and Reazaei (2016) found that overconfidence bias had no any significant impact when it came to the decisions about dividend policy of a company. Thus, the findings are mixed and it appears that there are other factors affecting this relationship. The above studies looked at different effects of CEO's overconfidence but there are few which looked at the effects of CEO overconfidence on dividend and therefore this study wants to fill this void by exploring not only the well-established firms but also the upcoming firms so as to fill the research gap.

1.2 Research Objective

The objective of this study was to determine the effects of Chief executive officer Overconfidence on dividend policy of Kenyan commercial banks.

2.0 Methods

Descriptive research design was used for the study. The population of the study consisted of all Kenyan commercial banks registered by the Central bank of Kenya which were 43 by the year 2017. The study used both Primary and Secondary data. Primary data was gathered through the administration of questionnaires that were filled by the respondents representing the 43 commercial banks whereas the secondary data used in the study was gathered using audited financial statements of commercial banks in Kenya which were obtained from Central bank of Kenya. Correlation and regression analysis was applied to evaluate the effect of CEO overconfidence on dividend policy. The equation which was used is shown below:

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$ Where;

Y= Dividend policy

β_0 = constant term; $\beta_1 - \beta_4$ = Beta coefficients (Intercepts for independent variables);

X_1 = CEO overconfidence

X_2 = Natural logarithm of total assets

X_3 = Liquidity ratio

ε = Error term.

3.0 Results

Table 1 indicates that overconfidence bias, size, liquidity ratio and dividend policy were highly correlated.

Table 1: **Correlation matrix**

Correlations

		Overconfidence Bias	LIQUIDITY_RATIO	SIZE	DIVIDEND_POLICY
Overconfidence Bias	Pearson Correlation	1			
	Sig. (2-tailed)				
	N	30			
LIQUIDITY_RATIO	Pearson Correlation	.129	1		
	Sig. (2-tailed)	.497			
	N	30	30		
SIZE	Pearson Correlation	.238	.129	1	
	Sig. (2-tailed)	.205	.497		
	N	30	30	30	
DIVIDEND_POLICY	Pearson Correlation	-.093	.003	.569**	1
	Sig. (2-tailed)	.625	.987	.001	
	N	30	30	30	30

Source: Author (2018)

To evaluate the overconfidence bias effect on dividend policy of commercial banks, Overconfidence bias was regressed against dividend policy. Two control variables, namely; bank size, liquidity ratio were included. Table 2 below shows the regression coefficients for the regression of dividend policy on overconfidence bias, liquidity ratio, and size.

Table 2: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1.416	.747		-1.896	.069
	Overconfidence Bias	-.189	.127	-.237	-1.487	.149
	LIQUIDITY_RATIO	-.088	.289	-.048	-.304	.763
	SIZE	.140	.035	.632	4.000	.001

The regression model had a constant of -1.416 while overconfidence bias, liquidity ratio, and size had coefficients of -0.189, -0.088, and 0.140 respectively. The resulting regression equation was:

$$\mathbf{Y = -1.416 - 0.189X_1 - 0.088X_2 + 0.140X_3}$$

Overconfidence bias had a regression coefficient of -0.189. This indicates that, overconfidence bias had a negative effect on dividend policy, the more overconfidence bias that a commercial bank sought; the resulting dividend policy would be lower. The coefficient of overconfidence bias had a significance probability of 0.149; since the p-value is greater than 0.05 then the effect of CEO over-confidence bias on dividend policy was not statistically significant.

Liquidity had a coefficient of -0.088. This indicates negative effect on dividend policy. Maintaining high liquidity ratios would result in declining the dividend policy. Liquidity ratio had a significance probability of 0.763 and thus showing that its effect on dividend policy was not statistically significant as the p-value is greater than 0.05. Size had coefficient of 0.140 with a significance probability of 0.001. This outcome showed that size had a positive effect on dividend policy and its effect was statistically significant as p-value was less than 0.05.

4.0 Conclusion and Recommendations

4.1 Conclusion

This study sought to establish the effect of CEO overconfidence bias on dividend policy of commercial banks in Kenya. The result of regression analysis indicated that CEO overconfidence bias had a weak negative impact on dividend policy and thus an increase in CEO overconfidence bias leads to a decrease in the dividend policy of the bank. Thus, the study concludes that CEO overconfidence bias has a weak influence on the dividend policy on Kenyan commercial banks

The study also assessed the effect of size on the dividend policy of the banks in Kenya. The results showed that size had a strong positive effect on dividend policy and therefore an increase in size will increase the dividend policy of the bank. Therefore, the study concluded that size had a significant effect on the dividend policy on Kenyan commercial banks. The study also examined the effect of liquidity on the dividend policy on Kenyan commercial banks. The findings established that liquidity had a weak negative effect on dividend policy and thus an increase in liquidity ratio leads to a decrease in the dividend policy of the bank. The study concluded that liquidity has a weak negative effect on the dividend policy of commercial banks in Kenya.

4.2 Recommendations

This study proposes that, banks should check on the rate of CEOs overconfidence because overconfidence bias appears to affect the dividend policy negatively. The study also recommends that the banks check on their liquidity ratios as the current ratios are negatively affecting dividend policy. As such, lower liquidity ratios would be preferred to offer better dividend policy for the commercial banks in Kenya. Increase in Size indicated that commercial banks to perform much better financially and thus the study recommend banks to maintain or increase on those variables so as to increase their dividend. Further, the study recommends that Central Bank of Kenya should offer an atmosphere where the commercial banks process is not hampered with. For example, CBK should ensure steadiness of interest rates so as to encourage lending. Through enhanced lending, commercial banks are able to gain commissions and fees. Fees and commissions form a significant portion of banks' non-interest income.

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