CEO Compensation: Evidence from the Field

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Existing CEO Pay Research

- Theory: Max E[V-c] s.t. IC, IR (which bind)
- Empiricists test predictions
- Max E[V-c]
  - Only downside of higher pay is direct cost
  - Objective may not be SV, but winning SoP
- IR binds
  - May not, esp. if outside option falls
- IC binds
  - Other ways to address moral hazard; other reasons for PPS
- Other constraints
  - History, media, employees, customers

Motivation for a Survey

- Goal: test *objectives*, *constraints*, and *determinants* of CEO pay
- Limitations of archival research
- Limitations of surveys
  - Certain questions may not elicit truthful responses

Survey Basics

- Directors
  - NEDs of FTSE All-Share Companies
- Investors
  - Fund managers, CIOs, and CG professionals at asset managers / asset owners who invest in UK
- Demographic data, but little XS variation

- In models, there's a single "principal": boards acting on behalf of shareholders
- Researchers recognizes agency problems: boards don't act on behalf of shareholders
  - But boards and investors may view the world differently

I. Objectives and Constraints

Rank the importance of the following goals when setting CEO pay

	Directors			Investors		
Importance	Most	Second	Least	Most	Second	Least
Attract/retain the right CEO	**65%**	32%	4%	44%	**48%**	8%
Design a structure that motivates CEO	34%	**61%**	5%	**51%**	42%	7%
Keep the quantum of pay down	1%	8%	**91%**	5%	10%	**85%**

- Reducing the level of pay is third-order vs.
  - Getting the right CEO (Gabaix and Landier, 2008)
  - Motivating the CEO (Edmans and Gabaix, 2011)

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- Boards focus on IR, investors more on IC
  - Weak boards
  - Uninformed boards
  - Uninformed investors

Uninformed Investors

- “This is becoming a joke. Good people are leaving public companies for private equity in droves. And governance people should get a proper job.”

Uninformed Investors

- “This is becoming a joke. Good people are leaving public companies for private equity in droves. And governance people should get a proper job. **I feel strongly about this**”

How large a sacrifice in shareholder value would you make to avoid controversy on CEO pay?

- 67% of directors / 56% of investors would sacrifice shareholder value to avoid controversy on CEO pay
  - IR and IC are far from the only constraints

How important is it to avoid controversy with the following parties?

	Directors	Investors
Investors	$\boxed{1.24}$	0.24
Employees	0.66	$\boxed{1.26}$
Proxy Advisors	0.44	-0.12
Customers	0.18	1.14
Policymakers	-0.01	0.92
Media	-0.06	0.17

Scale: -2 to 2

- Boards think that shareholders hinder maximization of shareholder value
  - "Shareholders appoint RemCos and then often seek to micromanage their duties"
- Many important parties ignored by models

The Consequences of Constraints

- 77% said they had to offer less pay than they would have liked to

Did having to offer less pay ever lead to the following consequences?

	Yes
The CEO was less motivated	42%
There were no adverse consequences	41%
We hired a less expensive CEO	12%
The CEO left	7%

- Efficiency wages due to fairness
  - "He was navigating in a highly volatile and complex situation. He still did the job, but his morale was affected negatively."
  - "There is first a test of pay fairness by the CEO, then after that, for most CEOs, it is about building reputation for the company and latterly themselves"
  - $U(c,x)$ not $u(c)$

II. The Level of Pay

How important are the following factors in determining the level of pay for a new CEO?

	Directors	Investors
The new CEO's ability	1.28	1.49
CEO pay at peer firms	0.83	0.46
How attractive our firm is to run	0.76	0.61
The new CEO's other employment options	0.55	0.26
The new CEO's pay in their previous position	0.28	-0.21
How financially motivated the new CEO is	0.06	-0.23
The outgoing CEO's pay	-0.01	-0.55

- Peer pay matters beyond labor market reasons

What causes you to increase the level of pay for an incumbent CEO?

	Directors	Investors
Good recent CEO performance	0.96	1.05
Increase in firm size	0.37	0.17
Increase in pay at peer firms	0.27	-0.17
Increased threat of CEO leaving	0.25	-0.06
Change in attractiveness (e.g. prestige, risk, complexity) of CEO job at your firm	0.22	0.25
Other changes that reduce the attractiveness of the pay package	-0.11	0.01
Change in attractiveness (e.g. prestige, risk, complexity) of CEO job at other firms	-0.29	-0.37

- *Pay incentives* matter, not just *portfolio incentives*

Why Should Performance Affect Pay?

- CEO cares not only about *consumption incentives*, but *ex-post recognition*
  - "To recognise achievement - the retrospective acknowledgement of exceptional performance is important"
- $U(c,\mathbf{x})$ rather than $u(c)$ determines recognition

If your firm reduced the pay of its next CEO by 1/3 compared to its current CEO, what might happen?

	Directors	Investors
We would recruit a lower quality CEO	0.66	-0.32
The CEO would be less motivated	0.39	-0.31
It would create undesirable pay compression between the CEO and other executives	0.36	-0.50
We would have a strained relationship with the CEO	0.32	-0.48
It would send a negative signal about CEO quality to the market	0.28	-0.36
There would be no adverse consequences	-0.95	$\boxed{-0.02}$

- Boards don't think they can cut pay – CEOs are at IR
  - But investors disagree

Directors think the CEO talent pool is scarce …

- “Could only avoid adverse consequences if the overall competitive market backdrop changes. Otherwise the best candidates would not be attracted at such a significant discount to "market" rates”
- “Really stupid question unless you are implying that current pay levels are totally unjustified”

… but investors disagree

- "CEOs should not be money motivated … CEOs that are wanting to use the company to get rich are not the right CEOs"
- "He might have a hissy fit … then the board should reconsider if this person is appropriate for the role"
- "CEOs should not just be motivated by quantum of compensation – that suggests they have the wrong person"

III. Variable Pay

What motivates your CEO to perform strongly?

	Directors	Investors
Intrinsic motivation	1.53	1.50
Personal reputation	1.41	1.60
Incentives from bonuses, LTIPs, equity, or future pay increases	0.97	0.83
Industry competition	0.61	0.82
The quantum of pay	0.55	0.21
The potential to move to a bigger firm	-0.55	0.37
Risk of being fired	-0.87	-0.20

- Incentives matter, but aren't the most important
- Labor market incentives are least important

Why do you offer the CEO variable pay?

	Directors	Investors
To motivate the CEO to improve long-term shareholder value	1.44	1.36
To attract/retain a high ability or hard working CEO	1.18	0.85
So that the CEO shares risk with investors and stakeholders, even if out of the CEO's control	1.17	1.14
To motivate the CEO to improve outcomes other than long-term shareholder value	0.44	0.47
To match peer firm practice	0.39	-0.45
Because investors or proxy advisors require it	-0.18	
So that the quantum of pay can be justified	-0.45	-0.34

- "To recognise achievement - the retrospective acknowledgement of exceptional performance is important"

Importance of cultural norms

- “A high proportion of variable pay runs through all levels of the organisation (commission at lower levels, annual bonuses at higher levels) and it therefore feels appropriate and a cultural alignment for the CEO to have a high mix of variable pay”
- “Also difficult to think of CEO scheme in isolation from EXBO and firm as a whole. Similar design principles.”

Do you believe industry conditions should be filtered out from all performance measures?

	Directors	Investors
No	63%	75%
Yes	37%	25%

Why don't you filter out industry conditions from all performance measures?

	Directors	Investors
The CEO should benefit from an industry upswing, since investors and stakeholders do	0.47	0.05
It is too difficult to define an appropriate peer group	0.22	-0.06
We don’t have information on peer performance for some measures	0.20	-0.12
Investors don’t want us to filter out industry conditions	0.14	
Benchmarking all performance measures would lead to the CEO mimicking peer	-0.25	0.14
Relative performance measures are less motivating for the CEO	-0.28	-0.46
In an industry upswing, not benchmarking performance keeps our pay competitive with peers	-0.31	-0.17
The CEO is responsible for choosing what industries our firm operates in	-1.05	-0.42

Theorists’ Explanations

- To prevent interim renegotiation, the manager must have private information that causes him to have a different view from the board on the value of his long-term pay. Industry prospects are an example of such private information, and so it can be efficient to make the contract contingent upon them
- Edmans and Gabaix (2009): “Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories”

What would happen if you made the CEO's incentives more long-term?

	Directors	Investors
The incentives would lose their effectiveness	0.19	-0.98
We would be unable to attract/retain the CEO we want	0.14	-0.81
We would have to pay the CEO more, which would outweigh any benefits	0.11	-0.95
The CEO would make better decisions	-0.42	1.14

Disagreement on desirability of long-term incentives

- "This would be a win win win win win. It would weed out CEOs that are in it for a quick buck, it would focus on long-term outcomes, and it would align CEOs with shareholders. If I could have a single bullet to improve governance, this would be it"
- "If we shifted the weighting more towards long-term schemes and away from the short-term bonus scheme I believe it would reduce its effectiveness"
  - Pay incentives vs. portfolio incentives
- "These steps have to be market moves not sole company moves"

IV. Summary

Summary

- Boards set pay under far more constraints than just IR and IC
  - These constraints bind and affect both level and structure
  - Main constraint is from investors
- Investors want IC to bind and think IR is slack
  - Boards perceive commercial pressures to be strong
  - Disagreement, not necessarily agency problems
- Financial incentives are not viewed as first-order motivators
  - But important to provide recognition incentives for fairness
  - Pay incentives matter, not just portfolio incentives
- Fairness concerns justify inefficient risk-sharing
  - Chaigneau, Edmans, and Gottlieb: A Theory of Fair CEO Pay