Discussion of CEO compensation: Evidence from the field

by

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The UK survey: overview and goals

- Non-executive directors of FTSE All-Share companies (excluding investment trusts; 27% board chairs, 33% RemCo chairs).
- Investors in UK equities: asset managers (80%)/owners (such as pension funds) – it includes both fund managers (26%) and governance specialists (52%).
- Goal: to understand the objectives and constraints of contract design, and to identify the determinants of pay.
- Constrast with standard theories of executive compensation.
- Can inform empirical work:
  - Directors and investors disagree because of “weak/uninformed boards” or because of “uninformed investors”?
  - What is the importance of fairness considerations in executive pay?

Findings of the survey (I)

- Principal-Agent “shareholder value” view: pay is set by a principal (shareholder-aligned board) subject to participation (IR) and incentive (IC) constraints. Manager risk aversion key.
- Standard assumptions of executive pay models do not describe how pay is actually set:
  - Boards face a much larger set of constraints than participation (IR) and incentives (IC):
    - Pay in peer firms affects new CEO pay because it affects what the CEO views as *fair*, rather than because of labor market competition.
  - There is no single principal: Directors and investors disagree on how to maximize shareholder value (and the latter must approve pay package):
    - *Investors* want boards to lower the level of pay and align incentives more to long-term shareholder value.
      - 77% of investors believe that pay is too high because boards are weak.
    - *Directors* believe that investors underestimate the difficulties of attracting and retaining CEOs, and that implementing investors’ wishes would demotivate the CEO or precipitate her departure.
    - Directors view attracting and retaining the CEO (satisfying IR) as the most important goal of pay, while investors believe that motivating the CEO (satisfying IC with long horizon of incentives) is more important.
      - Additional constraints (controversy, proxy advisors) forced 72% of directors to offer an inferior pay structure.

Findings of the survey (II)

- Incentives and variable pay (contrast with P-A model)
  - CEO’s intrinsic motivation and personal reputation as most important.
  - Financial incentives secondary and its role is to reinforce the former.
  - Incentive (flow) pay important for expost recognition, not for consumption.
  - Main determinant of pay variability is how much CEO can affect firm performance. Firm risk/CEO risk aversion *not* important.
  - Little use of relative performance evaluation and long-term incentives.
  - Fairness plays a big role (what others are paid, internal comparisons):
    - Importance of reference points for CEOs, directors and investors.
    - CEOs are expected to share external shocks with investors and stakeholders.
    - CEO’s pay should be sensitive to performance if employees’ pay is.

Corporate culture at the center of executive compensation

- Key ingredients of executive compensation: Intrinsec motivation, personal reputation, and fairness considerations.
- Spell out implications for corporate culture.

Questions

- How to incorporate fairness/recognition constraints in P-A model?
- Why two key predictions of theory are not always implemented: long-term incentives and relative performance evaluation?
- What explains often stratosferic and obscene levels of CEO pay when intrinsec motivation and personal reputation (over and above career concerns) are the drivers of effort?
  - Financial incentives are complementary (counterbalance empire bulding or engineering biases of intrinsec incentives).
- Discrepancy between directors and investors:
  - Because of differences in implementing solutions or capture of boards (“rent extraction” view: boards captured by CEOs/insiders to maximize pay/perks, not value)?

Comments

- Survey methodology:
  - Potential bias of respondents in directors and investor groups
    - Self-selection.
    - What are the implications of “governance experts” of funds/investors or board advisors of companies responding in the name of funds/directors: conform, look good.
- Controls, exploitation of differences between firms
  - with different levels of ownership concentration (large shareholders),
  - with different degrees of common owners (externalities),
  - facing different competitive pressure in the product market,
  - facing differences in the market for corporate control,
  - in different sectors (e.g. banking 24% of sample).

Ownership structure

- Ownership concentration: firms under the control of large shareholders have the potential problem of abusing minority interests and "tunneling" (La Porta et al., 1999): any difference in the survey responses between firms with concentrated and dispersed ownerhsip?
- Common ownership:
  - Firms with common owners may have executive remuneration less sensitive to performance (Anton et al., 2022), and with less (or even reverse) dependence on relative performance evaluation.
  - Managers of firms with common owners may care about external effects (e.g. in other sectors, Azar and Vives 2021; R&D spillovers, López and Vives, 2019; or environment, Azar et al.). Does it make a difference in executive compensation?
  - Managers of firms with a higher participation of passive well diversified funds (in relation to active investors/funds) will have more common ownership incentives (Banal et al. 2020, 2022).

Competitive environment

- *Product market*: firms operating in more competitive markets will have remuneration more sensitive to performance (evolutionary idea: otherwise they will not survive (Allen and Gale, 2000, Vives, 2000)).
- *Market for corporate control*: firms operating in jurisdictions with less obstacles to takeovers will lessen the capture of firms by insiders and will have a lower level of executive remuneration/perks (Hellwig, 2000).

Banking sector

- The standard model of incentive compensation when applied to banking executives should take account of
  - High leverage (conflict of interest between shareholders and depositors/debtors and depositor insurance fund).
  - Endogenous choice of risk or volatility of earnings.
  - Possibility of asset bubbles (e.g in real estate).
- With convex payoffs (limited liability, TBTF, …) increasing with volatility, shareholders and managers owning shares have an incentive to increase risk and volatility.
  - Evidence during the global financial crisis of 2007-2009.
- Proposals to link manager compensation to default risk.
- Regulation:
  - Requirements to vest remuneration of executives, claw-back clauses.
  - Strengthened prudential requirements.
- Do you see any evidence of differences in responses from banking institutions (24% of sample)?

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