Fair executive compensation

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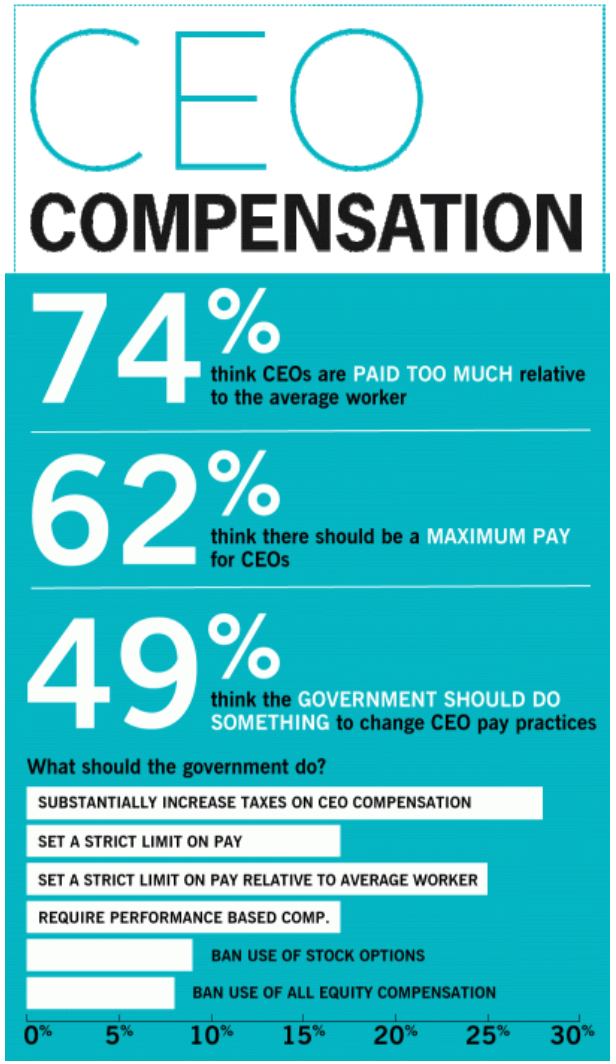
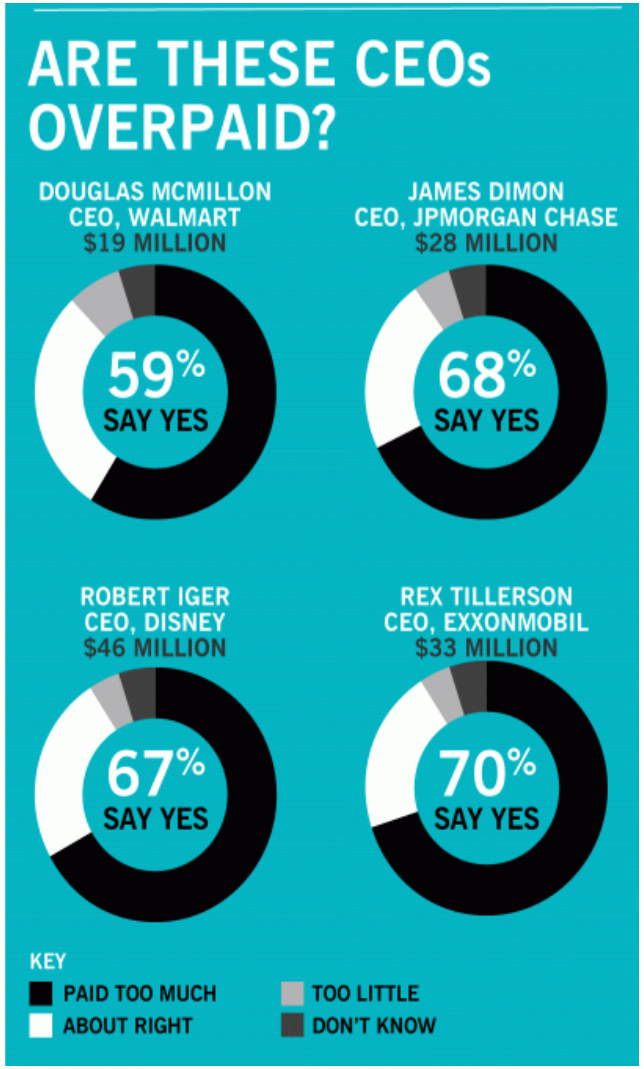
Executive compensation





Development of executive compensation practices

- CEO pay risen sharply over the past decades
  - During 1978-2014, CEO compensation has increased 997% when adjusted for inflation
  - Can make between 210 and 300 times the salary of their workers
- High salaries to draw top talent in a competitive market
- Economic factors and value add of a successful CEO

Public opinion

- CEOs are paid too much
- There should be a maximum pay for CEOs
- Governments should change CEO pay practices

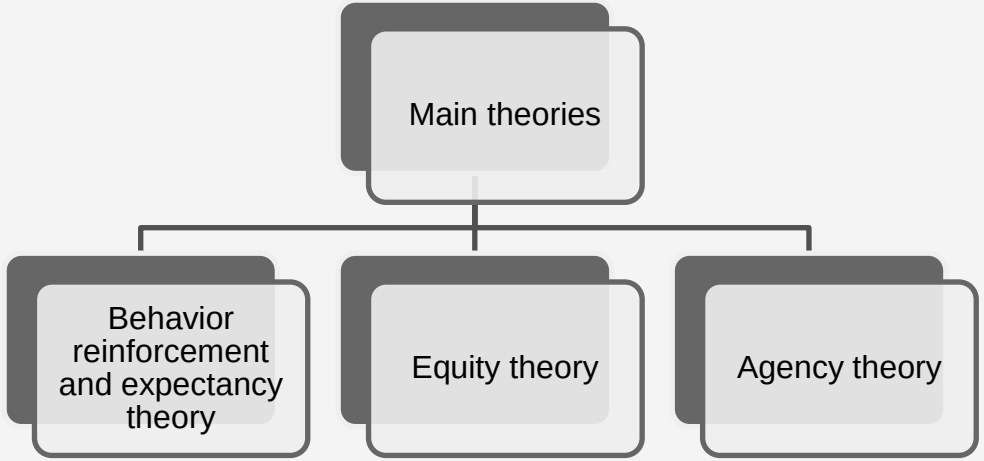
Academic research

- Many explaining factors for arisen executive compensation
  - Increased CEO demands and turnover reflected into risk premium
- Failures in communicating the value added of competent CEO
- Level of CEO compensation varies between different countries and industries
  - No academic evidence for a pay premium after controlling for firm, ownership and board characteristics

Question:

- Is executive compensation aligned with effective markets and agency theory or should CEO be paid less as indicated by the public opinion?

Compensation theories



Basics of compensation theories

- Used to establish efficient compensation management
- Mitigating labor and opportunity costs
- Structure and level of employee compensation
- Retaining and attracting top talent for minimal inputs

Behavior reinforcement and expectancy theory

- Reward-earning behavior is liskely to be repeated
- For what kind of efforts are employees being rewarded for?

Equity theory

- Perspective of uniformity and fairness
- Employee's actions are based on their perception of compensation
- Feeling and effect of employee under- or overcompensation

Agency theory

- Most common and widely accepted form of compensation theories
- Basis of our analysing
- Conflict of interests between the shareholders and executives

Agency theory

Basis of agency theory

- Conflicting interests between principals and agents
- Mitigating the issues of conflicting interests
- Aligning the acts of an agent with the principal's interests

Concept of agency loss

- Direct and undirect costs related to conflicting interests
- Amount that was "lost" due to the agent acting contrary to the principal's interests
- Multiple different ways to reduce the amount of agency loss

Applicability to executive compensation

- Aligning the interests of shareholders and executives
  - Level and structure of executive compensation
  - Long- and short-term incentives
  - Risk-premium reflected in the total compensation
- Typical arguments:
  I. CEO compensation has reached a level where further increases do not reduce agency loss
  II. As capable CEOs could be attracted with smaller compensation
  III. Increasing the pay of regular employees would increase the profitability more than higher CEO compensation
- Effective labor markets
  - Excessive CEO compensation resulting in diminishing shareholder returns?
  - Markets determine the level of CEO pay
  - Affects of governmental and societal factors

Mitigating agency loss through optimized executive compensation

Arguments against high executive compensation

- Public critique on high executive compensation is based on many different arguments
- Most of the literature has focused their critique on the following areas

Critique on Performance based pay

Critique on Attracting talented individuals

CEO and Board dynamics

Critique on Performance-based pay

The management and shareholders have different interests
-> Performance-based pay.
On a general level performance-based pay works as an incentive to improve one's productivity
<u>However:</u>

- Performance-based pay has **diminishing returns** or can even be counterproductive
  (Mishra et. al., 2000)
- There is only a **small relation** with CEO wealth and shareholder wealth (Jensen & Murphy, 1990)
- **Only 4% of the variance** in CEO pay is due to firm performance
  (Tosi et al., 2000)

Critique on Attracting talented individuals

High executive pay is supposed to attract talented individuals to the firm. CEO credentials such as education and career affect positively on pay and performance especially in larger firms. (Falato et al., 2015)

Opposing views:

- There are **very small differences in CEO talent** which still cause substantial differences in their pay (Gabaix & Landier, 2008)
- CEO characteristics such as education, experience or tenure have **no significant effect** on differences in pay (Fernandes et al., 2013)
- Bad governance can result overpaying CEOs especially in smaller firms (Dicks, 2012)
- For executive pay to be considered "fair" the **company should get value for their money**. In situations where the compensation levels are inflated due to bad practices and the talent is overvalued this is not the case.

CEO and Board dynamics

One of the board's tasks is to choose the optimal compensation level and structure for the CEO. Therefore, CEO and board dynamics play an important role in determining the CEO compensation.

- CEOs have too much say about their own compensation
- Undercompensated CEOs are more likely to push **benchmarking their compensation** on top paying firms (Shin, 2016)
- Factors such as tenure, social standing and additional board positions affect the power that the CEO has. For example, **interlocking boards may result to collusion** (Hermalin & Weisbach, 2003)
- Non-US companies justifying the adoption of US type of compensation. Non-US CEOs could undertake US market activities **forcing the board to adopt the higher US pay-practices** (Gerakos et al.,2013)

Arguments on behalf of high compensation

- If the **marginal cost** of paying CEO more is **less than the benefits** from it, the pay increase is **justified** and in the best interests of the company

- Only a **small fraction** of companies don't have majority of favorable shareholder votes for their pay policies (Kaplan 2012)
    - Evidence from S&P 500 and Russel 3000

Reducing agency costs

- One of the most **common arguments**
- Better corporate governance

Attracting and retaining talent

- Talented individuals need to be motivated and feel respected
- **CEO pay hasn't been increasing in 2000s**. It has declined in relation to other high paying professions (Fernandes et al. 2013) (Kaplan, 2012) It has also increased less since 1980 than private companies' CEOs (Bakhija et al. 2012). Smaller compensation might lead to the **talent leaking elsewhere**

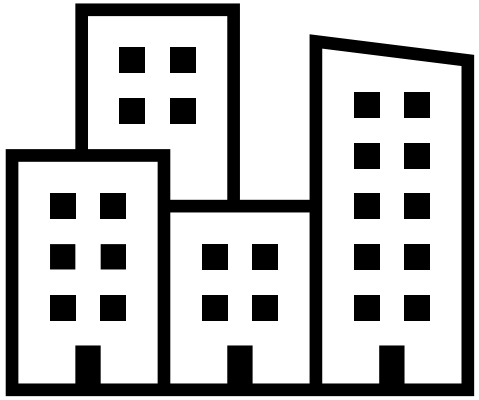
Compensation for higher risks and bigger responsibilities

- Important reason behind recent decades' CEO pay increase

Reasons behind current high CEO pay

- Size and complexity of the company
- Proportion of performance-based pay
- Ownership structure and board characteristics

Size of companies



Big part of the pay increase from 1970s can be explained **with firm size growth** (Gabaix et al. 2008)

- They have been increasing almost in line

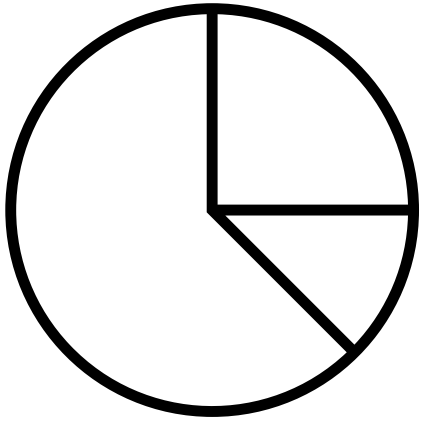
Bigger firms generally pay CEOs more (Core et al. 1999)

- **Harder to run**
- **More and bigger responsibilities**
- Capability to pay more if seen as wise thing to do

CEOs demand to be compensated for **more difficult job**

- Need to be paid more to **retain them**

Proportion of Performance-based pay



Pay-for-performance sensitivity has increased a lot since late 1980s (Gabaix et al. 2008)

- **Aligned interests**, Clear correlation between stock returns and CEO pay (Kaplan and Rauh) 2010

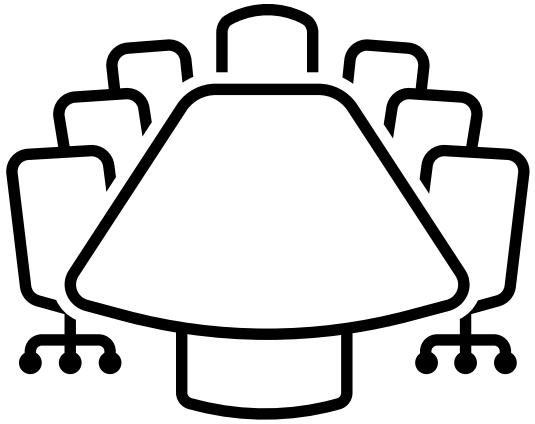
Generally, leads to higher compensation as it is **riskier** and can result in big earnings when targets are exceeded

- Especially when **equity-based**

Changes in **ownership structure** and **board characteristics** some of **the leading factors** behind pushing for more performance-related pay

- Factors leading to higher pay for CEO

Ownership structure and board characteristics



Ownership structure and board independence affect the amount and function of the pay of CEO (Fernandes et al. 2013)

- **Smaller** board and **more outside** members -> more independent
- High **institutional ownership** and independent board -> higher compensation

Lately institutions have become more **active owners** (Dai, 2007)

- Push for pay-for-performance and tighter monitoring
- In the **best interest of all shareholders**

Also, board independence is emphasized more and has **similar effects**

Demand for **higher-ability** CEOs, higher **probability of being fired** and **risks** regarding compensation

- -> higher pay

Conclusion

- Public's opinions:

- General belief is that CEOs are being **overpaid** for what they actually do

- Why CEOs compensations are fair:

- The growth in the **size** and **complexity** of firm, meaning more responsibilities for CEOs and better ability for companies to compensate.

- CEOs payment is increasingly tied to **performance of firms**, and thus CEOs are in fact paid for their good job running the business

- Change in ownership structure toward more **institutional owners** and more **active ownership**, meaning more long-time holdings, and focus on long-term success for firms and thus higher compensation to align interest of shareholders with CEOs

- Supported by the theory of efficient markets. Shareholders have **no incentives to overcompensate** for their work efforts in an efficient labor market.