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Corporate governance and CEO compensation in Indian firms

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ABSTRACT

We examine the role of the board, ownership, and CEO characteristics in CEO compensation in Indian firms. Contrary to the evidence documented in prior studies, we find that CEO compensation is not associated with board characteristics. Instead, compensation is associated with firm's ownership attributes and its CEO's tenure. We also document that leaving out CEO fixed effects in a longitudinal compensation study can lead to potentially erroneous conclusions about the role of several governance attributes in CEO compensation contracting. Finally, we find that CEO compensation attributed to ownership characteristics in the private sector is positively related to future firm performance, whereas remuneration attributed to board and CEO characteristics in both private and public sectors are not. Our evidence is consistent with efficient CEO compensation contracting, rather than CEO rent extraction, in Indian firms.

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1. Introduction

Academics, government representatives, as well as business media have raised their concerns over high CEO compensation in Indian firms and have indicated the failure of corporate governance and regulation to curb rent extraction and excessive compensation (Bose, 2014; Chakrabarti et al., 2012; Ghosh, 2010; Jaiswall and Firth, 2009; Pande and Dubey, 2014; Rai, 2009; Singh, 2007). They suggest that CEOs collude with their firm's board to draw higher compensation. Though prior research has examined the determinants of total CEO compensation in Indian firms, it has not formally investigated whether CEO compensation exhibits rent extraction or alternatively whether CEO compensation contracting is efficient. Furthermore, compensation studies in the Indian context use a small sample, over a limited period, and have methodological concerns pointed out by Graham et al. (2012) and Petersen (2009).[1] Consequently, the evidence for the role of corporate governance in CEO compensation in Indian firms suffers from limited generalizability, omitted variable bias, and inflated statistical significance. These arguments indicate an incomplete understanding of the association of CEO compensation contracting with corporate governance in Indian firms.

In this study, we examine the association between CEO compensation and board, ownership, and CEO characteristics in Indian firms and investigate whether higher CEO compensation reflects rent extraction or efficient contracting.[2] Using improved methods, we attempt to fill the void and contribute to a better understanding of CEO compensation contracting in India.

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[1] The issue is not restricted to compensation studies in the Indian context. Compensation studies from other settings (such as Caylor and Lopez, 2013, Fernando and Xu, 2012, Firth et al., 2006, etc.) also do not cluster standard errors by firm and/or include managerial fixed effects.

[2] We use the words compensation, pay, and remuneration synonymously.

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According to Chakrabarti et al. (2012), Jaiswall and Firth (2009), and Tomar and Korla (2011), the level of CEO compensation is related to both ownership structures and board attributes.[3] However, we posit that total CEO compensation is associated with ownership attributes and not board attributes in Indian firms. Shareholding in Indian firms is concentrated in the hands of the promoters and financial institutions, who typically own the largest and second largest proportion of a firm's equity, respectively (Chakrabarti et al., 2012; Sarkar and Sarkar, 2000).[4] These shareholders have the financial incentive to monitor the management and curb rent extraction (Shleifer and Vishny, 1986). Large shareholders including promoters and institutional investors play an active role in monitoring management (Sarkar and Sarkar, 2000). For example, the Government of India annually evaluates its companies on their performance along financial and non-financial parameters. In contrast, boards play an advisory role in guiding management (Cappelli et al., 2010; Sarkar and Sarkar, 2009) and not a monitoring role (Cappelli et al., 2010; Haldea, 2010). For example, independent directors are appointed for fulfilling regulatory norms rather than for actively monitoring the management (Haldea, 2010). Therefore, we expect that CEO compensation in Indian firms would be associated with ownership structures instead of board attributes.

Our study uses a sample of 5045 CEO-year observations over the period 2002–2013. The sample is much larger, over a longer duration, and more representative of Indian firms than the samples used in prior compensation studies in an Indian setting. Thus, the role of a firm's corporate governance in CEO compensation documented in our study is more likely to be generalizable across Indian firms. Our study employs a pooled linear regression with CEO fixed effects. The empirical specification explains 85% of the variation in total CEO compensation, about twice of that explained in prior compensation studies based on Indian firms. To investigate whether CEO compensation reflects rent extraction or efficient contracting, we improvise upon the empirical approach of Core et al. (1999) and examine the associations between compensation attributed to the board, ownership, and CEO characteristics and future firm performance.

Our study provides interesting insights for researchers, policy makers, and board members. First, the results show that leaving out CEO fixed effects can lead to erroneous conclusions about the role of governance attributes in CEO compensation contracting in the Indian scenario. Therefore, our study confirms the importance of including CEO fixed effects in longitudinal compensation studies. When managerial fixed effects are included in compensation regression, Graham et al. (2012) document a change in the magnitude and/or statistical significance of the coefficients of observed managerial attributes and the economic determinants of compensation; however, their empirical model did not have ownership and board characteristics as explanatory variables. Our study extends Graham et al. (2012) by documenting that the magnitude and/or the significance of the coefficients on ownership and board attributes also change when CEO fixed effects are included. Second, our study documents that CEO compensation is associated with ownership structures and not board attributes in Indian firms. This differs from the prior evidence of the role of both board and ownership structures in CEO compensation in Indian firms. Third, our study finds that compensation is not different for CEOs who are also the board chair or a promoter and in firms with larger boards or fewer independent directors. Therefore, these CEOs do not earn higher pay, contrary to the evidence from prior studies based on Indian firms. Fourth, the determinants of CEO compensation in the private sector firms are quite different from the determinants in the public sector firms. In particular, blockholders play an important role by monitoring and constraining CEO compensation in private sector firms, whereas in public sector firms, CEO compensation has an insignificant sensitivity to firm performance and a negative sensitivity to firm risk. To the best of our knowledge, our study is the first to document such differences in the Indian context. Lastly, we document a positive association between CEO compensation related to the ownership structures and future firm performance in the private sector. We also find a non-significant association between CEO compensation attributed to the board and managerial characteristics and future firm performance in both the private and the public sectors in India. Thus, we do not find evidence to suggest rent extraction in private and public sector firms in India unlike those in the USA (Core et al., 1999). Rather, our evidence indicates that ownership structures have a role in CEO compensation contracting in the private sector.

Our paper is organized as follows: Section 2 reviews the empirical literature on CEO compensation, describes the Indian institutional environment, and develops the hypotheses. Section 3 describes the sample and the empirical methodology. Section 4 provides the summary statistics and presents the results. Finally, Section 5 concludes the study.

2. Literature review and motivation

2.1. Review of the literature on executive compensation

Executive compensation literature has documented that the boards tie CEO compensation to firm performance not only to reward CEOs for superior firm performance but also to align their incentives with those of the shareholders. The choice of performance measures in compensation contracting differs across countries. CEO compensation is associated with stock return in the USA (Core et al., 1999), Japan (Kaplan, 1994), South Korea (Kato et al., 2007), Australia (Clarkson et al., 2011), and China (Kato and Long, 2006), but not in India (Jaiswall and Firth, 2009), due to the sparse use of equity-based pay in Indian firms (Balasubramanian et al., 2010). Instead, a positive association between CEO compensation and ROA (return on

[3] Chakrabarti et al. (2012), Jaiswall and Firth (2009), and Tomar and Korla (2011) report a significant coefficient on at least one board attribute and at least one ownership attribute.

[4] "Promoter" is widely used in India to refer to any person who directly or indirectly controls a firm.

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