



Asymmetric benchmarking of pay in firms

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ARTICLE INFO

Article history:

Received 29 January 2012

Received in revised form 20 July 2013

Accepted 23 July 2013

Available online 29 July 2013

JEL classification:

D8

G3

J3

Keywords:

CEO compensation

VP compensation

Benchmarking

Pay for luck

ABSTRACT

This paper examines whether asymmetric benchmarking of pay exists for vice presidents (VPs). Using ExecuComp data for 1992–2007, we find that companies reward VPs for good luck but do not penalize them for bad luck. However, asymmetric benchmarking of VP pay is mitigated by governance, CEO power, gender, and industry factors. The presence of asymmetric benchmarking of pay could suggest that managers are involved in skimming, or it could mean that firms insulate managers from poor firm performance to prevent them from accessing outside opportunities. We find that unlike CEOs, asymmetric benchmarking of pay for VPs is not consistent with the skimming hypothesis.

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1. Introduction

The leaders who work most effectively, it seems to me, never say “I.” And that’s not because they have trained themselves not to say “I.” They don’t think “I.” They think “we”; they think “team.” They understand their job to be to make the team function. They accept responsibility and don’t sidestep it, but “we” gets the credit. This is what creates trust, what enables you to get the task done.

[Peter F. Drucker]

The importance of teams cannot be understated. Top management team members or vice presidents (VPs) play an especially important role in firms.¹ They make and implement investment and financing decisions, and they act as a link between a CEO and the rest of the organization. In addition to making decisions that impact firm value, VPs also engage in bottom-up monitoring of the CEO; that is, they perform the crucial function of internal governance (Landier et al., 2012). Most research has been dedicated to either examining overpayment to CEOs or the burgeoning pay gap between the top management and lower level employees. However, in order to run a firm efficiently, a CEO must secure the loyalty and trust of his management team. Since the dynamics

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¹ Vice President (VP) – member of the top management team besides the CEO.

between a CEO and the remainder of his team are significant, we focus our attention on VPs in this paper. Specifically we investigate VP compensation contracts.

Standard principal–agent models predict that managerial pay should be tied to firm performance. Empirical evidence has shown that in fact VP pay is sensitive to firm performance (Aggarwal and Samwick, 2003; Indjejikian and Matejka, 2009; Rajan and Wulf, 2006). Therefore VPs' wealth increases if a firm performs well. Recent studies on CEO pay, however, have highlighted that asymmetric benchmarking of pay, where compensation contracts are sensitive to firm performance only when performance is good but not when it is bad, exists for CEOs (Garvey and Milbourn, 2006). That is, CEOs are paid for good luck and protected from bad luck.

In this paper we examine whether VP pay is also asymmetrically benchmarked to firm performance. We should expect VP pay to be asymmetrically benchmarked because the disparity of pay between VPs and CEOs may attenuate their loyalty to the CEO and/or promote envy (Dur and Glazer, 2007). CEOs anticipating this behavior may find it optimal to protect VPs from bad luck. Another rationale for asymmetrically benchmarking VP pay is that CEOs may derive non-pecuniary benefits from obtaining favorable contracts for their team (Jensen and Meckling, 1976). Wade et al. (2006) show that overpaid CEOs positively influence pay of employees in a firm.

Asymmetric benchmarking of VP pay may be absent if the CEO is a dominant player (Bebchuk et al., 2011). Bebchuk et al. (2011) contend that CEOs are able to exert excessive power over their compensation contracts, capturing a major chunk of the compensation payout to the top management. This expansion of gap in pay between the CEO and the remaining top management is indicative of CEO power and raises fairness concerns. Various measures of gaps in CEO versus VP pay have therefore been linked to a decrease in firm value (Bebchuk et al., 2011; Carpenter and Sanders, 2002; Siegel and Hambrick, 2005).

Asymmetric benchmarking of pay is an important issue because shareholders are concerned about rewarding managers for unobservable skill and not the observable luck component of firm performance. Therefore when pay is asymmetrically benchmarked to luck it is considered sub-optimal and is labeled as skimming. Skimming implies that managers have gained control over the pay-setting process (Bertrand and Mullainathan, 2001; Garvey and Milbourn, 2006). However, when managers have outside options, it may be more efficient for firms to index their wages to the market (Oyer, 2004). In this case asymmetric benchmarking of pay may help firms in retaining key personnel, thereby making it optimal contracting. In sum, the two points of view have contrasting motives for asymmetric benchmarking. The retention hypothesis contends that asymmetric benchmarking enhances firm value, whereas skimming argues that it destroys firm value.

To examine whether compensation of VPs is asymmetrically benchmarked, we use a sample of ExecuComp firms over the period 1992–2007. We follow Garvey and Milbourn (2006) and conduct our analysis in two stages. In the first stage, we estimate luck and skill by regressing firm returns on industry returns. The predicted values from this regression are termed as luck and residual is termed as skill. In the second stage, we examine the relationship between compensation and our measures of luck and skill.

We find that luck and skill both have a positive relationship with VP compensation. To capture the asymmetry in benchmarking of pay, we create a dummy variable called *Luckdown*, which equals one when luck is negative, and zero otherwise. This variable is then interacted with our measure of luck and is called *Badluck*. If asymmetric benchmarking exists in a firm, then the coefficient on this interacted variable would be negative and significant, which means that a manager receives lesser luck based pay when luck is bad. Consistent with asymmetric benchmarking, we find that the coefficient on *Badluck* is negative, indicating that VPs are rewarded for good luck and not penalized as much for bad luck. The presence of asymmetric benchmarking of pay for VPs implies that their compensation contracts are designed similarly to those of CEOs.

Bertrand and Mullainathan (2001) and Garvey and Milbourn (2006), among others, argue that governance mitigates asymmetric benchmarking of pay. To investigate the role of governance we look at G-Index (governance index)² and E-Index (entrenchment index).³ In the case of G-Index, we find that VPs and CEOs are paid for luck and they are protected from bad luck when governance is strong. When governance is weak, VP pay is insensitive to bad luck and the CEO experiences significantly more protection from bad luck compared to his strong governance counterpart. In firms with low entrenchment, both CEOs and VPs are protected from bad luck. Similar to weak governance firms, we find that CEOs receive significant protection from bad luck and VP pay is insensitive to bad luck in highly entrenched firms. The difference in sensitivity of pay between good and bad governance firms points to the role of governance in mitigating asymmetric benchmarking of pay. However, VP compensation contracts exhibit lesser variability in different governance regimes, suggesting that their contracts may have been symmetric or optimal to begin with.

Adams et al. (2005) argue that powerful CEOs wield considerable influence over firms' investment and financing decisions. Further several studies have shown that CEOs and to a lesser degree, other team members, can at times have a significant influence on compensation proposals (Bebchuk et al., 2011; Grinstein and Hribar, 2004; Murphy, 1998). However Wade et al. (2006) argue that if CEOs are overpaid, similar trends can be observed for managers in a firm. We therefore explore power differences: when an executive is also a director, both the CEO and VPs are rewarded for luck and protected from bad luck. When

² Gompers et al. (2003) create a G-index of shareholder rights of 1500 U.S. corporations for 1990–1999 on a scale of 1 to 24. Companies in the first decile that had a governance score below 5 were deemed part of the democratic portfolio, and firms in the last decile that had a governance score above 14 were deemed part of the dictatorship portfolio.

³ The entrenchment index is based on the six items out of the corporate governance index: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. Together, these six items, based on Bebchuk et al. (2008), represent CEO entrenchment.

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