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CEO control, corporate performance and pay-performance sensitivity

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ABSTRACT

Agency theory suggests that high pay-performance sensitivity (PPS) of CEO's compensation is an important motivation mechanism to the CEO to improve corporate performance. We develop a simple model that suggests that reverse causality should also be considered. Specifically, our model predicts that when good performance is expected, a powerful CEO will push for a contract with higher PPS. Data from 135 Israeli companies over a five-year period confirm the model's main prediction. Our empirical analysis shows that when the CEO is the chairman of the board of directors and thus is more powerful in affecting his compensation scheme, he achieves a high PPS in good periods (in terms of corporate performance), compared to similar powerful CEOs in periods of bad performance, and also compared to less powerful CEOs in good periods.

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1. Introduction

The recent financial crisis demonstrated once again the importance of executive compensation, and in particular the dangers associated with managerial incentive schemes that create asymmetries between the optimal risk for the firm and the risk that the incentive schemes encourage the managers to take. An important branch of corporate governance research in recent years deals with the determinants of executive compensation. This research suggests two alternatives to explain the governance-compensation relations: the arm's-length and the managerial power approaches.

The arm's-length approach suggests that executive compensation schemes are being designed by the board of directors at arm's-length, to provide managers with proper incentives to act in the best interest of shareholders, increase firm value and reduce agency costs.[1] However, the growing public as well as academic criticism over both compensation levels and

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[1] For the basic ideas of the agency problem see Jensen and Meckling (1976). For a review of empirical studies see Jensen and Murphy (1990), Cosh and Hughes (1997), and Amzaleg and Mehrez (2004).

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sensitivity to the corporate performance, suggests that conflicts of interests and agency problems are to some extent inherent to executive compensation schemes.

This criticism is reflected in the managerial power approach, which adopts a more realistic view and relaxes the basic assumption that boards of directors design optimal compensation schemes. Instead, this approach suggests that managers with some level of controlling power tend to influence their own compensation arrangements. Bebchuk and Fried (2003), for example, argue that managerial power and incentives to extract economic rents are likely to have an important influence on the design of executive compensation contracts.[2] Specifically, this view suggests that executive compensation is a mechanism through which valuable resources are being transferred from shareholders to managers when corporate governance is weak and the CEO is highly powerful vis-à-vis the board. Harris (2009), for example, stated "incentive pay ultimately exacerbates the very agency problem it is purported to solve." The abundant empirical evidence basically confirms the main hypothesis of the managerial power approach, which suggests that a more powerful CEO does in fact extract economic rents (see Bebchuk and Fried (2004) for a review of empirical evidence). A substantial body of evidence indicates that pay is higher when executives have more controlling power. For example, Core et al. (1999) find that the CEO pay is higher when the CEO is also the chairman of the board, when corporate governance mechanisms are less effective and when the board is larger, older and subject to CEO's control. The known implications of such rent extraction activity by the CEO include higher compensation level (Smith and Watts, 1992; Amzaleg and Mehrez, 2004), higher consumption of perks, empire building through value decreasing mergers and acquisitions (Girma et al., 2002), reduction of manager's risk through corporate project selection, and earnings management (Laux and Laux, 2009). Bertrand and Mullainathan (2001) find within a skimming frame model that better-governed firms induce a more efficient compensation system that pays their CEO less for luck and for unexpected events. Garvey and Milbourn (2006) find significantly less pay for luck in periods of bad luck (when paying for luck reduces compensation) than in periods of good luck. This asymmetry is also affected by the level of corporate governance, and "it appears to be marginally more prominent in situations in which the CEO could have greater influence over her pay, such as is exemplified in a firm with weaker corporate governance." There are several important differences between this result and ours. First, Garvey and Milbourn (2006) consider the issue of paying for luck whereas we look at the overall compensation as a function of ROA. Second, they use the Corporate Governance Index data constructed by Gompers et al. (2003), whereas we consider whether the CEO was a chairman of the board or not. They use US data while we look at Israeli data. Finally, they find that the impact of corporate governance on the asymmetry is marginal, whereas we find that the CEO being the chairman of the board multiplies the relevant coefficient by six.

Focusing on the relationship between the CEO's control and compensation the natural question is how does a powerful CEO, with high control over the board and over the compensation structuring process, extract rents? The answer seems quite obvious at first. He uses his influence to "force" the board to pay him more. While to some extent this is probably true, one must also consider that any crude attempt to increase total remuneration with no good "excuse" will probably raise massive "public outrage"[3] followed by intense objection by the company's regulators and stake holders (e.g., shareholders, debt holders, and institutional investors).[4] Consequently, the powerful manager's problem is how to extract rents with minimum "public outrage." Since high compensation level is very easy to monitor, and is thus constrained, the CEO has to be more creative and sophisticated in camouflaging his rent extraction.[5] Studying the implications of the manager's need to mask his rent extraction activities is reflected in both the theoretical and the empirical literature. Some camouflage mechanisms for rent extraction have been discussed in previous research. For example, firm size is an important factor of executive compensation level. Running a larger company requires better skills and knowledge and carries greater responsibility of the manager, which should be reflected in his compensation level. However, there is evidence suggesting that a powerful CEO increases company size through value-decreasing mergers and acquisitions partly as an excuse to increase his own compensation level (Amihud and Lev, 1981; Bliss and Rosen, 2001). Other masking instruments include low exercising prices of granted options and surprisingly "good timing" (i.e., just before stock price went up) of options granted to the CEO (Yermack, 1997). Bebchuk and Fried (2004) further suggest that Supplemental Executive Retirement Plan (SERP) make an attractive choice for executives with power to extract rents due to their obscurity.

[2] See also Kole (1997) and Finkelstein and Hambrick (1989).

[3] For an empirical example, see Marilyn et al. (1997), who find public scrutiny (as expressed in negative press reports) to be negatively related to CEO's total salary and positively related to the sensitivity of compensation to corporate performance. Another example is Core et al. (2008), who find a strong positive relation between CEO's excess compensation and negative press coverage. As Richard Breeden, former chairman of the U.S. Securities and Exchange Commission puts it: "The best protection against abuses in executive compensation is a simple weapon – the cleansing power of sunlight and the power of an informed shareholder base" (Breeden, 1992).

[4] For example, Hartzell and Starks (2003) find a negative relationship between the extent of institutional ownership and executive compensation levels. Amzaleg et al. (2009) find that mutual funds tend to exhibit a higher level of voting involvement when compensation issues are at stake.

[5] Throughout this paper we use excessive pay as the main implication of rent extraction. Nonetheless, a higher than normal compensation level is only one form of agency costs related to the compensation structure. The desire to camouflage or facilitate the extraction of rents can lead to the use of inefficient pay structures that weaken or distort incentives and create further agency costs to the firm. As mentioned earlier, the recent financial crisis in the US and worldwide is to some extent evidence of inefficient executive compensation schemes.

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