Rémunération des dirigeants : L'allocation des talents est-elle efficace ?

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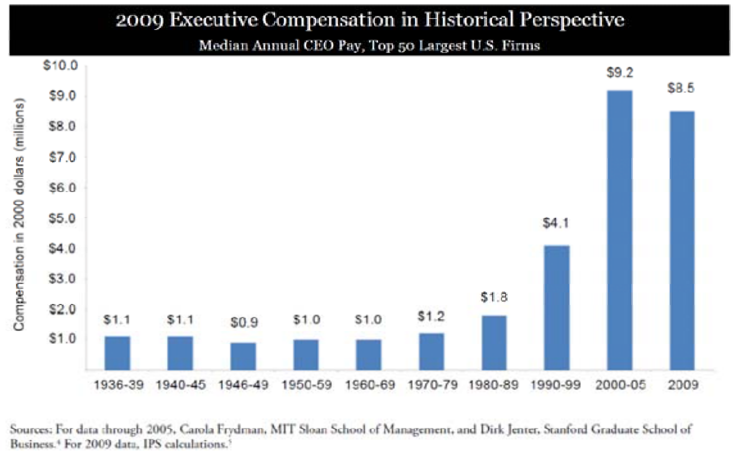
Chaire FDIR, November 2, 2010

CEO pay: the revenge of Labour vs. Capital?

- CEO pay has litteraly exploded over the last three decades…

An extraordinary rise of CEO pay…

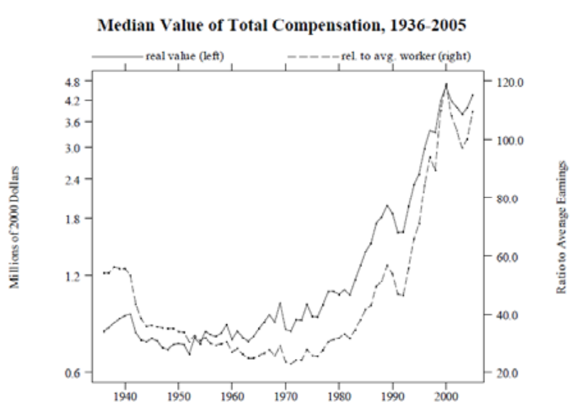
- Median CEO compensation (including stock gains) over 1936-2010



Sources: Institute for Policy Studies

accompanied by an extraordinary rise in wage ratio…

- Wage ratio followed…

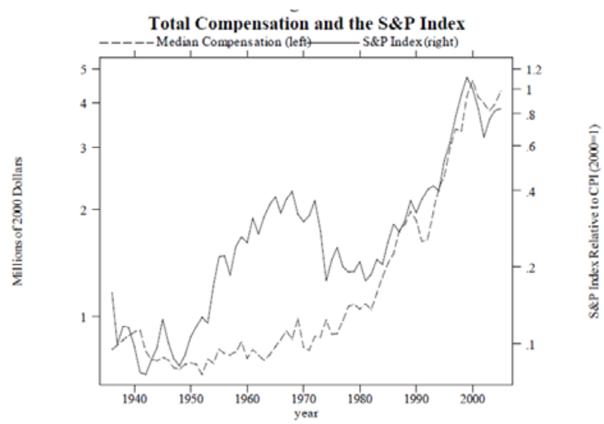


Note: Total compensation is composed of salary, bonuses, long-term bonus payments, and stock option grants. Relative compensation is defined as total compensation divided by total wage and salary accruals per full-time equivalent employee from table 6.6 of the National Income and Product Accounts. Based on the three highest-paid officers in the largest 50 firms in 1940, 1960 and 1990.

Source: Frydman, Saks. Executive Compensation: A New View from a Long-Term Perspective, 1936-2005, FED

along with an extraordinary rise in shareholder value.

- … Along with the shareholder value

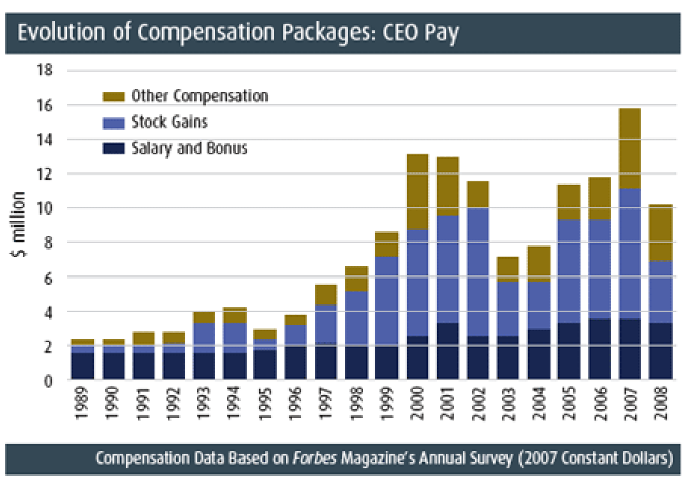


Note: Total compensation is composed of salary, bonuses, long-term bonus payments, and stock option grants. Based on the three highest-paid officers in the largest 50 firms in 1940, 1960 and 1990. The S&P index is expressed relative to the CPI and equals 1 in 2000.

Source: Frydman, Saks. Executive Compensation: A New View from a Long-Term Perspective, 1936-2005, FED

Increase has been for the most part stock-based

- Stocks and stock-options make up for the most part of the increase:



Source: FTI.

Why should we care?

We might be tempted to ask: “why should we care?”

- Compensation part of a private contract between shareholder and employee. Agreement reached is in theory optimal for both parts.
- There is a market for talent, and salaries are fixed by supply and demand.
- Regulation can be counterproductive, beware of the “law of unintended consequences”.

Why we should care

1. Top execs compensation accounts for a significant proportion of firm’s shareholder value => **shareholders should care**
2. Compensations induce tax => **taxpayers should care**
3. Almost all compensation schemes are asymmetric (no downside) => **regulators should care**
4. CEO’s decisions might be affected by compensation schemes => **stakeholders should care**
5. An ethical issue after all => **citizens should care**

But

6. Talent is a market, management skills are a rare resource to be allocated optimally. This market should be given means to function optimally.

Today’s context

- G20 on bonuses
  - 3 year delay, stock-based comp, no guaranteed bonuses
- US: Dodd-Frank act
  - Say on Pay, compensation committees, disclosures
- UK: bonus tax
- France: Loi de régulation bancaire et financière
- Special measures for aided firms:
  - Compensation caps, “Compensation Czars”

What does economic theory have to say?

- Four stories
  - Costly incentives
  - Efficient talent allocation
  - Technological shift
  - The skimming theory
- Very different stories, truth is a mix.
- Importance of making the right diagnostic.

1. The incentive story

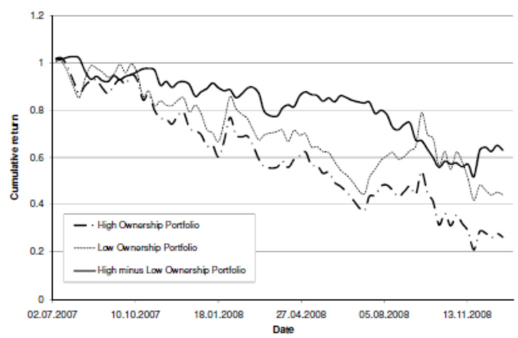
- CEOs should have an incentive to act in the interest of the shareholder.
- Agency theory: Jensen and Mekling (1976).
- Are US CEOs paid like bureaucrats?
  - in the early 1980s: yes (Jensen and Murphy (1990))
  - At the start of the 1990s, no longer (Hall & Liebman (1998))
- 2000's and the hyper-incentives

Incentive failure?

- Generally held opinion: stock-options value increase with volatility, incentive CEOs to take risk.
- Fahlenbrach, Stulz (2009) show that bank CEOs before crisis held on average equivalent of 10 years of compensation in their own stock, and that those who were more incentivized did not lose less
  - Ambiguous role of incentives schemes in 07 crisis

Incentives and the crisis

The figure shows cumulative weekly portfolio returns for a portfolio of high CEO ownership financial firms, for a portfolio of low CEO ownership banks, and for a long-short portfolio where the high CEO ownership banks are bought. Firms are classified as high ownership if the ownership of the CEO at the end of fiscal year 2006 is in the top quartile of all sample CEOs. Ownership is a dollar ownership measure, which is equal to the dollar change in the executive's portfolio for a 1% change in the stock price.



Source: Fahlenbrach, Stulz - Bank CEO incentives and the credit crisis, 2009. ssrn.com.

Did incentives work?

	Bear Stearns		Lehman	
	CEO	Executives 2-5*	CEO	Executives 2-5*
2000	$9,087,527	$51,578,462	$57,136,184	$16,137,797
2001	$37,351,798	$119,906,815	$38,444,262	$43,949,470
2002	$30,062,992	$81,730,685	$31,088,600	$34,432,387
2003	$67,400,196	$250,500,025	$52,770,933	$39,981,325
2004	$32,252,656	$130,232,072	$20,329,964	$62,903,572
2005	$25,128,912	$106,092,399	$98,565,177	$71,694,762
2006	$11,704,049	$34,306,481	$108,651,865	$57,873,403
2007	$15,445,977	$32,667,187	$53,544,175	$62,332,550
2008	$60,653,974	$10,223,482	$642,454	$10,630
TOTAL	**$289,088,081**	**$817,237,608**	**$461,173,614**	**$389,315,896**
Total Top-5	**$1,106,325,689**		**$850,489,510**	

Source:Bebchuk, Cohen and Spamann. The Wages of Failure (2010). ssrn.com.

2. The efficient allocation story

- Talent is a market. Allocation is costly
  - Rosen's "superstars" model
  - Gabaix and Landier (2006) paper: size matters
- Highlights the role of competition between firms – talent supply is constant
- But
  - Is it so much about money? What about nonmonetary payoffs?
  - Are talented CEOs most productive within large firms?
  - Is the market rewarding talent – or charisma?

Size and CEO compensation

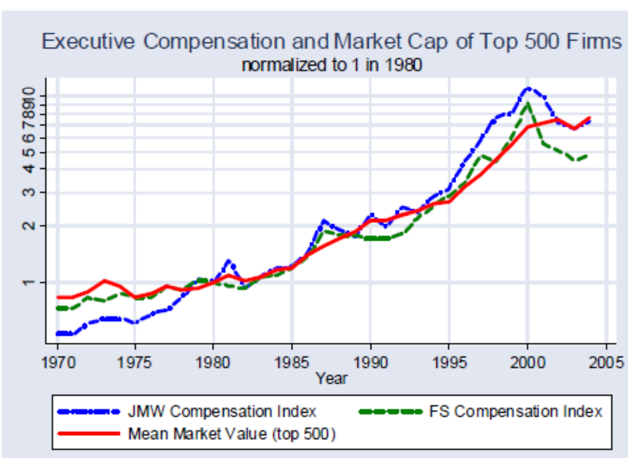


Figure I: Executive Compensation and Market Capitalization of the top 500 Firms. FS compensation index is based on Frydman and Saks (2005). Total Compensation is the sum of salaries, bonuses, long-term incentive payments, and the Black-Scholes value of options granted. The data are based on the three highest-paid officers in the largest 50 firms in 1940, 1960 and 1990. JMW Compensation Index is based on the data of Jensen, Murphy and Wruck (2004). Their sample encompasses all CEOs included in the S&P 500, using data from Forbes and ExecuComp. CEO total pay includes cash pay, restricted stock, payouts from long-term pay programs and the value of stock options granted, from 1992 onward using ExecuComp's modified Black-Scholes approach. Compensation prior to 1978 excludes option grants, and is computed between 1978 and 1991 using the amounts realized from exercising stock options. Size data for year t are based on the closing price of the previous fiscal year. The firm size variable is the mean of the largest 500 firm asset market values in Compustat (the market value of equity plus the book value of debt). The formula we use is mktcap=(data199*abs(data25)+data6-data60-data74). To ease comparison, the indices are normalized to be equal to 1 in 1980. Quantities were first converted into constant dollars using the Bureau of Economic Analysis GDP deflator.

Source: Gabaix and Landier (2006).

3. The technological change story

- Technology changes, informational rent of some employees (execs but also traders) increases in value
  - Garicano and Rossi-Hansberg (2006)

4. The skimming theory

- Bertrand and Mullinathan (2001): “Are CEOs rewarded for luck?” take a measure for “luck”: oil prices, and show that CEO compensation varies with that factor.
  - Proper incentive scheme should be able to distinguish effect of CEO’s efforts.
- Bebchuk, Cohen and Spamann (2010) find that top executive from Bear Stearns and Lehman cashed in substantial profits, even in bad times.
  - Compensation schemes are not really aligned on the long term interestof the shareholder
- Compensation as an alibi for oligopolistic practices

Adjusting answers to diagnostic

- Better incentives
  - 3 years period
  - Cf. Bebchuk
- Better disclosures
  - Mandatory expensing of execs stock options
  - Dodd-Frank act disclosures
- Better corporate governance
  - “Say on Pay”
  - “Compensation Czars”
- Legal limitation: different effects
  - Tax/Cap: Bonus tax, TARP cap, etc.
  - Llense (2010): distortion may be less severe than you’d think

Conclusions

Importance of distinguishing 2 debates

- Compensation in industrial sector firms.
  - Wage inequality more sensitive; industrial performance and value creation rewarded
  - Solutions? Better disclosure; better corporate governance

- Compensations in finance
  - often less a governance issue
  - Compensations as an alibi?
  - Solutions? Ensure competition between financial sector firms; distinguish performance from luck or from rents