Are CEOs Accountable for Performance?

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This is taken from my 16/2/17 response to the UK government's Green Paper on Corporate Governance. The full response is at http://bit.ly/AlexCorpGov.

1.1 Paragraph 1.1 of the Green Paper states that "*there is a widespread perception that executive pay has become increasingly disconnected from … the underlying long-term performance of companies*". This perception is unambiguously incorrect. Almost all studies showing this result are unpublished, because they make a major error in measuring incentives. They study how pay (salary, bonus, and new equity grants) changes with performance. But the vast majority of incentives come from the CEO's *existing equity holdings*. These studies – and Figure 1 in the Green Paper – ignore these holdings. It is no surprise that they find that incentives are low, since they miss the vast majority of incentives.

1.1.i As an analogy, it is well-accepted that the size of an investor's stake measures how much he loses from poor firm performance. Similarly, a CEO's stake measures how much she loses.

1.1.ii I recognise that there are many issues on which there is academic debate and lack of consensus, e.g. due to ambiguity in methodology. On this point, however, there is no debate from *any* top academic – the incentive measure must include equity holdings. Indeed, the direct effect of equity holdings is so large that the indirect effect of performance on changes in salary, bonus, and new equity grants can be ignored. There are four academic "handbooks" on executive compensation, and *all four* make this point. (A "handbook" is the "how to" on a topic, similar to a textbook for practitioners, and contains the accepted methodology):

- Core, Guay, and Larcker (2003) write: "*we focus on the incentives to increase the stock price provided by the manager's ownership of equity … the vast majority of a typical CEO's incentives to increase stock price are driven by variation in the value of his stock and option portfolio, that is, not by flow compensation*".
- Frydman and Jenter (2010) write: "*We only consider changes in executive wealth that are driven by revaluations of stock and option holdings. This channel has swamped the incentives provided by annual changes in pay*."
- Murphy (2013) writes: "*Virtually all of the sensitivity of pay to corporate performance from the typical CEO is attributable to the direct rather than indirect part of the CEO's contract*".
- Edmans and Gabaix (2016) write: "*The vast majority of incentives stem from changes in the value of previously granted stock and options, which swamp changes in cash pay*".

The size of a CEO's stake can be unambiguously measured, just like the size of an investor's stake. We do not even need to keep track of when the CEO accumulated her stake (just as we do not with an investor's stake). Indeed, the measure of incentives stemming from existing equity grants is so widely accepted that it has a simple name, "delta". One can use the term "delta" without explaining its calculation as everyone knows what it means and how it is calculated.[1] Similarly, any paper that omits existing equity is almost certainly rejected.

This view is also held by leading practitioners, not just academics. For example, PwC (2017) write: "*Analysing pay using only flow measures of pay is a bit like analysing investment returns using dividends but ignoring capital gains. In other words, it makes no sense*."

1.1.iii Similarly, I recognise that there are issues on which it is difficult to disentangle correlation from causation. Paragraph 1.4 of the Green Paper states that "*It is difficult to assert with confidence the link between executive pay and long-term company performance … evidence does suggest a correlation between the pay of CEOs and company performance, but it is harder to establish a strong causal link*". This is actually not one of these cases. Poor performance automatically causes a fall in the value of her equity holdings, so causation is immediate.

1.1.iv These stakes, and thus potential losses, are sizable. The average FTSE 100 CEO holds £8 million. A 10% price fall costs her £800,000, equivalent to a £1.5 million pre-tax pay cut.

References

Core, John E., Wayne R. Guay, and David F. Larcker. 2003. "Executive Equity Compensation and Incentives: A Survey." *Federal Reserve Bank of New York Economic Policy Review* 9, 27-50.

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Murphy, Kevin J. (2013): "Executive Compensation: Where We Are, and How We Got There." In *Handbook of the Economics of Finance, Volume 2A: Corporate Finance*, edited by George M. Constantinides, Milton Harris, and Rene M. Stulz, 211-356.

PwC (2017): "Paying for Performance: Demystifying Executive Pay."

[1] The only possible methodological choice is whether to scale the measure. However, regardless of the scaling, *all* measures contain only incentives from previously-granted equity.