CEO Compensation: Evidence from the Field

Alex Edmans (LBS, CEPR, and ECGI)
Tom Gosling (LBS)
Dirk Jenter (LSE and CEPR)

LBS Centre for Corporate Governance / ECGI
October 2021

Standard Research Techniques

- Theory: build models solving for the optimal contract given circumstances
  - E.g. Bengt Holmstrom, Oliver Hart
- Concern: "models make unrealistic assumptions"
  - But realism may not be necessary

- Which "unrealistic" features are innocuous … and which are not?

Standard Research Techniques (cont'd)

- Empirics: analyse data to study what determines pay
  - But many key determinants are hard to measure (e.g. risk appetite)
  - Also, a relationship (e.g. link between pay and performance) doesn't tell you *why* that relationship exists

Our Approach: A Survey

- Directors
  - NEDs of FTSE All-Share Companies
- Investors
  - Fund managers, CIOs, and CG professionals at asset managers / asset owners who invest in UK

I. Objectives and Constraints

Standard Model

1. Minimise pay, subject to
2. Retention
3. Incentivisation

Rank the importance of the following goals when setting CEO pay

	Directors			Investors		
Importance	Most	Second	Least	Most	Second	Least
Attract/retain the right CEO	**65%**	32%	4%	44%	**48%**	8%
Design a structure that motivates CEO	34%	**61%**	5%	**51%**	42%	7%
Keep the quantum of pay down	1%	8%	**91%**	5%	10%	**85%**

- Reducing the level of pay is third-order vs.
  - Getting the right CEO (Gabaix and Landier, 2008)
  - Motivating the CEO (Edmans and Gabaix, 2011)

Rank the importance of the following goals when setting CEO pay

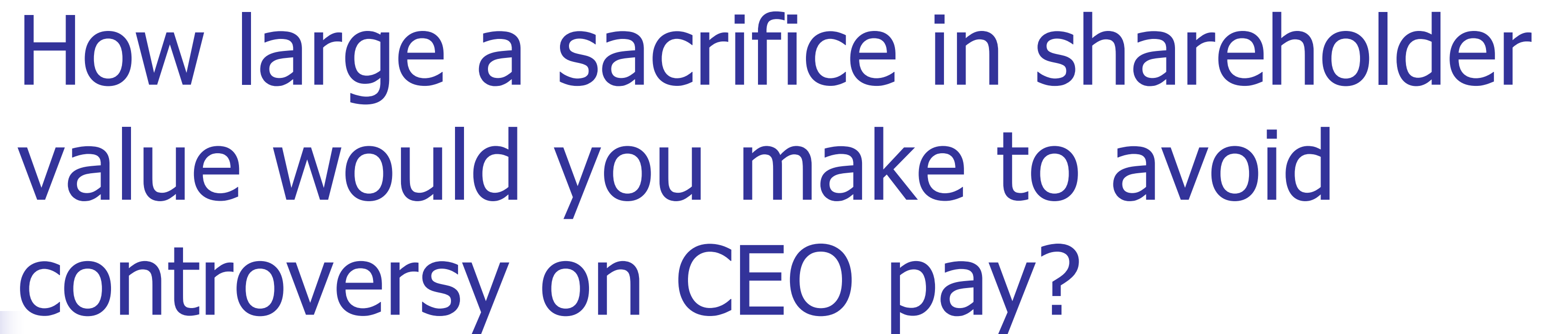
	Directors			Investors		
Importance	Most	Second	Least	Most	Second	Least
Attract/retain the right CEO	**65%**	32%	4%	44%	**48%**	8%
Design a structure that motivates CEO	34%	**61%**	5%	**51%**	42%	7%
Keep the quantum of pay down	1%	8%	**91%**	5%	10%	**85%**

- Boards focus on retention, investors more on incentivisation
  - Weak boards (Lucian Bebchuk)
  - Uninformed boards
  - Uninformed investors

Did having to offer less pay ever lead to the following consequences?

	Yes
The CEO was less motivated	42%
There were no adverse consequences	41%
We hired a less expensive CEO	12%
The CEO left	7%

- Efficiency wages due to fairness
  - "There is first a test of pay fairness by the CEO, then after that, for most CEOs, it is about building reputation for the company and latterly themselves"
  - Pay matters not for *consumption*, but *fairness* relative to a reference point



How large a sacrifice in shareholder value would you make to avoid controversy on CEO pay?

- 67% of directors / 56% of investors would sacrifice shareholder value to avoid controversy on CEO pay
  - Retention and incentivisation are far from the only constraints

How important is it to avoid controversy with the following parties?

	Directors	Investors
Investors	88%	44%
Employees	63%	82%
Proxy Advisors	48%	30%
Customers	44%	75%
Policymakers	32%	65%
Media	29%	43%

- Boards think that shareholders hinder maximization of shareholder value
  - "Shareholders appoint RemCos and then often seek to micromanage their duties"
- Many important parties ignored by models

II. The Level of Pay

How important are the following factors in determining the target quantum of pay for a new CEO?

	Directors	Investors
The new CEO's ability	85%	90%
CEO pay at peer firms	67%	49%
How attractive our firm is to run	67%	50%
The new CEO's other employment options	58%	43%
The new CEO's pay in their previous position	41%	23%
How financially motivated the new CEO is	37%	24%
The outgoing CEO's pay	33%	15%

- Peer pay matters beyond labor market reasons
  - It may be a relevant reference point

What causes you to increase the target quantum of pay for an incumbent CEO?

	Directors	Investors
Good recent CEO performance	76%	75%
Increase in firm size	46%	45%
Increase in pay at peer firms	44%	27%
Increased threat of CEO leaving	43%	30%
Change in attractiveness (e.g. prestige, risk, complexity) of CEO job at your firm	44%	45%
Other changes that reduce the attractiveness of the pay package	28%	30%
Change in attractiveness (e.g. prestige, risk, complexity) of CEO job at other firms	19%	16%

- *Pay incentives* matter, not just *portfolio incentives*

Why should performance affect pay?

- CEO cares not only about *consumption*, but *recognition*
  - “To recognise achievement - the retrospective acknowledgement of exceptional performance is important”
  - CEO’s perceived contribution is a second reference point

If your firm reduced the target quantum pay of its next CEO by 1/3 compared to its current CEO, what might happen?

	Directors	Investors
We would recruit a lower quality CEO	59%	18%
The CEO would be less motivated	46%	24%
It would create undesirable pay compression between the CEO and other executives	51%	16%
We would have a strained relationship with the CEO	45%	12%
It would send a negative signal about CEO quality to the market	49%	23%
There would be no adverse consequences	10%	33%

- Boards don't think they can cut pay, but investors disagree

Directors think the CEO talent pool is scarce …

- “Could only avoid adverse consequences if the overall competitive market backdrop changes. Otherwise the best candidates would not be attracted at such a significant discount to "market" rates”
- “Really stupid question unless you are implying that current pay levels are totally unjustified”

… but investors disagree

- "CEOs should not be money motivated … CEOs that are wanting to use the company to get rich are not the right CEOs"
- "He might have a hissy fit … then the board should reconsider if this person is appropriate for the role"
- "CEOs should not just be motivated by quantum of compensation – that suggests they have the wrong person"

III. Variable Pay

Why do you offer the CEO variable pay?

	Directors	Investors
To motivate the CEO to improve long-term shareholder value	89%	87%
To attract/retain a high ability or hard working CEO	87%	69%
So that the CEO shares risk with investors and stakeholders, even if out of the CEO's control	84%	79%
To motivate the CEO to improve outcomes other than long-term shareholder value	52%	53%
To match peer firm practice	49%	15%
Because investors or proxy advisors require it	31%	N/A
So that the quantum of pay can be justified	27%	25%

- "To recognise achievement - the retrospective acknowledgement of exceptional performance is important"

What would happen if you made the CEO's incentives more long-term?

	Directors	Investors
The incentives would lose their effectiveness	43%	5%
We would have to pay the CEO more, which would outweigh any benefits	39%	5%
We would be unable to attract/retain the CEO we want	38%	6%
The CEO would make better decisions	22%	78%

Disagreement on desirability of long-term incentives

- “This would be a win win win win win. It would weed out CEOs that are in it for a quick buck, it would focus on long-term outcomes, and it would align CEOs with shareholders. If I could have a single bullet to improve governance, this would be it”
- “If we shifted the weighting more towards long-term schemes and away from the short-term bonus scheme I believe it would reduce its effectiveness”
  - Pay incentives vs. portfolio incentives
- “These steps have to be market moves not sole company moves”

IV. Backup Slides

What motivates your CEO to perform strongly?

	Directors	Investors
Intrinsic motivation	92%	91%
Personal reputation	91%	96%
Incentives from bonuses, LTIPs, equity, or future pay increases	76%	68%
Industry competition	61%	67%
The quantum of pay	55%	37%
The potential to move to a bigger firm	18%	46%
Risk of being fired	11%	25%

- Incentives matter, but aren't the most important
- Labor market incentives are least important

How strongly do you agree with the following statements for why the overall level of CEO pay is so high?

	Investors
Boards are ineffective at lowering it even though they should	86%
Investors have insufficient power over boards to lower it	56%
Investors focus their engagement on more important topic than the level of pay	36%

Investors view boards as weak; boards view investors as ignorant of the realities of attracting and motivating CEOs