CEO Pay-Performance Relationships

Debate about pay practices for corporate CEOs continues but is there really a disconnect between CEO compensation and performance?

A look at the recently released 2013 compensation packages awarded to the world's top banking CEOs is further evidence that when it comes to paying the upper echelons of business there's been little tightening of purse strings.

Citigroup boosted CEO Michael Corbat's compensation 25 percent to about $14.4 million. Bank of America CEO, Brian Moynihan's salary and bonus was increased 17 percent to $14 million while JPMorgan Chase, after paying over $20 billion in regulatory fines and penalties, raised its CEO, Jamie Dimon's compensation package to $20 million, (albeit the bulk being in restricted stock).

And it's not just in the banking sector where figures are climbing. The GMI Ratings' 2013 CEO Pay Survey found compensation for CEOs of S&P 500 companies increased 19.65 percent at the median pushing many of the top earners into even higher brackets.

CEOs matter

How well-deserved these seemingly exorbitant packages are is a matter of contention. While the figures have been popularly deplored some market commentators believe they deserve more, which again raises the question does a CEO's pay accurately reflect his or her ability and how much value does a CEO bring to a company?

Although there is surprisingly little direct evidence whether CEOs contribute positively to firm value, Gilles Hilary, INSEAD Associate Professor of Accounting & Control says, yes CEOs do matter. And a leader's remuneration reflects both a firm's performance and financial market perception of the corporation – as long as the company's governance is good.

In the paper **CEO Ability, Pay and Firm Performance**, Hilary and co-authors, Yuk Ying Chang, Massey University's Senior Finance Lecturer and Sudipto Dasgupta, Chaired Professor of Finance at HKUST Business School, looked at a cross section of firms and found when good governance is in place and share-holder rights are strong compensation is actually a positive predictor of performance.

"Even when comparing differences within a particular industry or with other companies, our results are consistent with the view that … better compensated CEOs deliver higher performance and are better valued by both financial markets and other employers," Hilary told INSEAD Knowledge.

The research assessed 298 voluntary and forced CEO departures in the U.S. between 1992 and 2002 on three factors: stock market reaction to the departure; the subsequent success of the CEO in the managerial labour market and the performance of the firm after the CEO leaves.

"The advantage of our multi-pronged approach is that it leaves little room for alternative explanations," Hilary notes. "For instance while it could be argued that CEOs 'jump ship' or are forced to quit when the firms future prospects look dim, this would not explain why the manager's subsequent job prospect is positively related to past pay."

While the study looked at CEOs who held their position well before the onset of the Global Financial Crisis, he expects the results stand today not just in the U.S. but around the globe.

Strong boards key to linking pay and performance

"I would imagine the general finding that when governance is good a correlation between performance and compensation exists, but of course the quality of governance varies across jurisdictions."

And that's the crux.

While the findings in general disprove the skeptics view that CEOs are paid well simply because they are in a position to extract better compensation from their boards, analysis of a subset of firms where CEOs were entrenched and governance was poor, showed evidence that remuneration was more rent extraction than compensation for performance.

That firms with more responsible governance principles have stronger results, both economically and statistically, suggests responsible company management plays a very important role in determining pay-performance relationships.

The role of the board in assessing compensation also brings into question how an executive's performance is evaluated.

"Legally the duty of the CEO in most jurisdictions is to the firm not to the shareholders but in practice the people who can fire him or her are the shareholders – or board members working on behalf of the shareholders - so there's clearly tension here between what the law says and what the practice is," says Hillary noting that how much impact this has when considering compensation depends on how important the different groups are to the firm and where the CEO and board's allegiance lies. All of which adds fuel to the ongoing debate on whether the sole purpose of a firm and its CEO is to create value for its shareholders.

'Dumbest idea in the world'

Shareholder primacy is no longer a "given" in the thinking of contemporary business experts. Even former GE CEO, Jack Welch, once seen as a model for the shareholder value theory, has changed his tune. "On the face of it shareholder value is the dumbest idea in the world," he told the Financial Times in an interview after the onset of the Global Financial Crisis. "Shareholder value is a result not a strategy … Your main constituencies are your employees, your customers and your products."

When it comes to compensation Hillary agrees.

When setting compensation levels, he says it's up to the board to look at other ways to consider other ways of measuring a CEOs success rather than solely looking at share price.

*Gilles Hilary is Associate Professor of Accounting and Control at INSEAD. He is also a contributing faculty member at the **INSEAD Corporate Governance Initiative***

Follow INSEAD Knowledge on Twitter and Facebook