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 288 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 firm’s 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 CEO’s success rather than
solely looking at share price.