Corporate Governance and Relative Performance Compensation

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Thesis 1

Good corporate governance requires that the compensation system aligns the interests of top executives with those of the company’s shareholders.

Thesis 2

In the majority of companies (listed in the stock market) the compensation system for top executives fails to align their interests with those of their shareholders.

Thesis 3

A key reason for the failure to align the interests of top executives with those of their shareholders is the absence of efficient relative performance compen-sation.

Thesis 4

The absence of an efficient relative performance compensation system for top executives is a key indicator for a weak corporate governance system.

Rationale for Thesis 1

- Follows from the legal constitutions of listed companies
- Top executives need to act in the shareholders' interests. That is what they are paid for

Evidence for Thesis 2 – Failure to align interests

- An efficient compensation system should not reward luck but real performance
- Yet, a considerable part of CEO compensation is due to luck and not to performance
- Interestingly, bad luck is much less often punished than good luck is rewarded

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Paying for luck – the example of the US oil industry

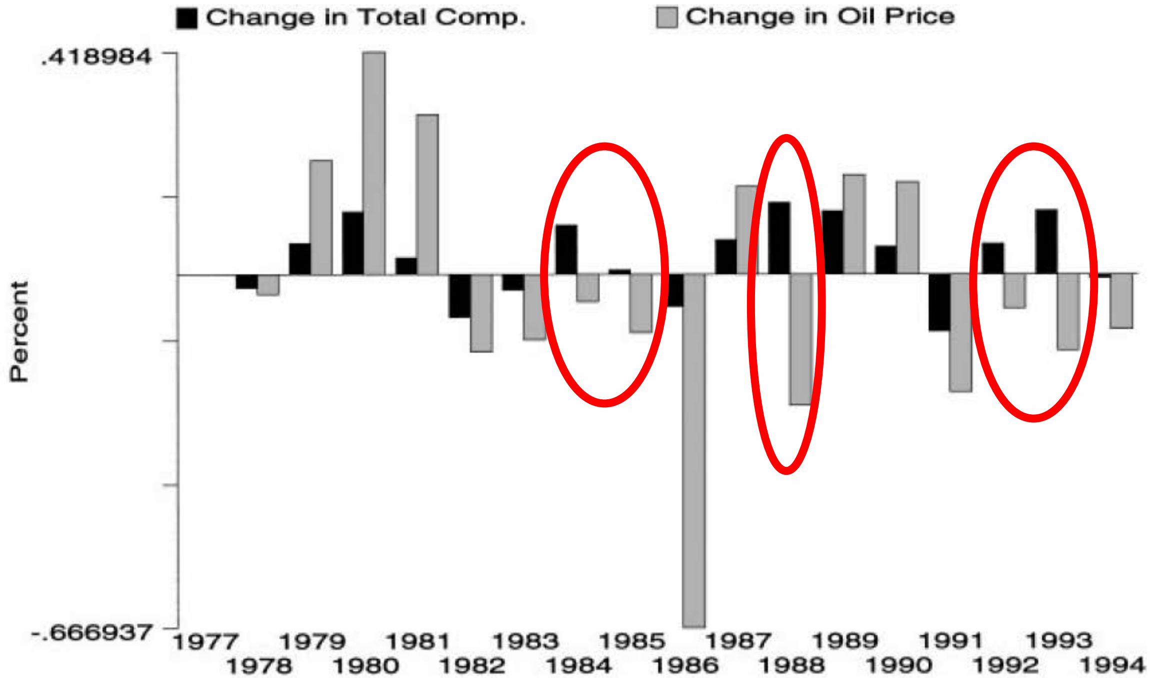


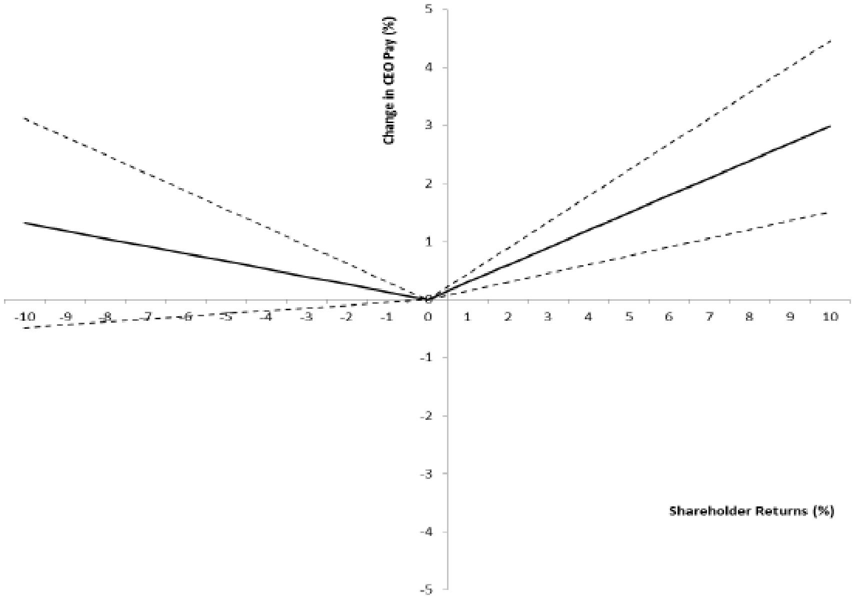
FIGURE III
Oil Industry CEO Pay and Crude Oil Price

Reward for luck holds more generally in a sample of firms that regularly appear in the Forbes 500 ranking

Paying for luck – the overall evidence

- Bertrand & Mullainathan (2001, US data):
  - «In fact, we find that CEO pay is as sensitive to a lucky dollar as to a general dollar. Moreover, these results hold as well for descretionary components of pay – salary and bonus – as they do for options grants.»
- Bell and van Reenen (2016, UK data):
  - In the UK «'pay for luck' appears very prevalent, just as in Bertrand and Mullainathan (2001)

Asymmetric treatment of good and bad luck or performance, respectively



Notes: Theses figures represent the implied effect of a percentage change in TSR (shareholder returns) on the percentage increase in CEO pay. The coefficients are from the specification in column (5) of Table 4. 95% confidence intervals shown.

Bell & van Reenen (2016): Firms with a low share of institutional shareholders

Rationale for Thesis 3

- Relative performance compensation can ensure paying for performance instead of luck
- Why? Because random factors – «good luck and bad luck» – generally affect a larger number of companies
  - «A high tide lifts all boats simultaneously – a low tide lowers all of them»
- Examples
  - Price fluctuations, exchange rate fluctuations, monetary policy shocks, business cycle fluctuations

Rationale for relative performance compensation

- Subtracting the performance of a comparison group of firms from the target firm's performance, we receive a purified performance indicator that removes random fluctuations

- Paying top executives based on the purified indicator greatly reduces payment for mere good luck and punishment for mere bad luck – thus fostering pay for performance

- Ideally, top executives are paid based on an evaluation of their firm's relative performance

Merely formal RPC does not suffice because of typical mistakes in applications

1. Top executives have the ability to choose a self-serving (low-performing) comparison group
2. Mistaken belief that the comparison group must consist exclusively of peers from the same industry
   - Performance indicator for members of the comparison group should have a high correlation with the target firm's PI
3. Low PI leads to a re-adjustment of parameters of the compensation scheme (e.g. issuing of more equity in the future)
4. RPE is not applied when performance is weak
   - «Forgiveness discussions» in Comp Committee

Preliminary Summary

- Relative Performance based compensation (RPC) is a superior way of compensating top executives
- It yields a better performance indicator that provides better incentives
- Tends to enhance long run profitability
- But only a minority of firms show some components of RPC
- For the seven firms examined from the sample of firms that is present today, none seems to put much weight on RPC

Why don't we see proper RPC more frequently?

1. Lack of appropriate knowledge among relevant players
   - Most consultants don't know the principles underlying RPC and how it can be properly applied
2. Requires a strong company board that knows the principles of RPC and is willing to implement these principles
   - CEOs want to be rewarded for good luck and often negotiate conditions that insulates them from bad luck
3. Board often lacks incentives to risk a conflict over RPC with their CEOs (i.e., corporate governance is weak)
   - Hypothesis: boards with activist institutional shareholders that hold a larger share make CEOs more accountable for real performance

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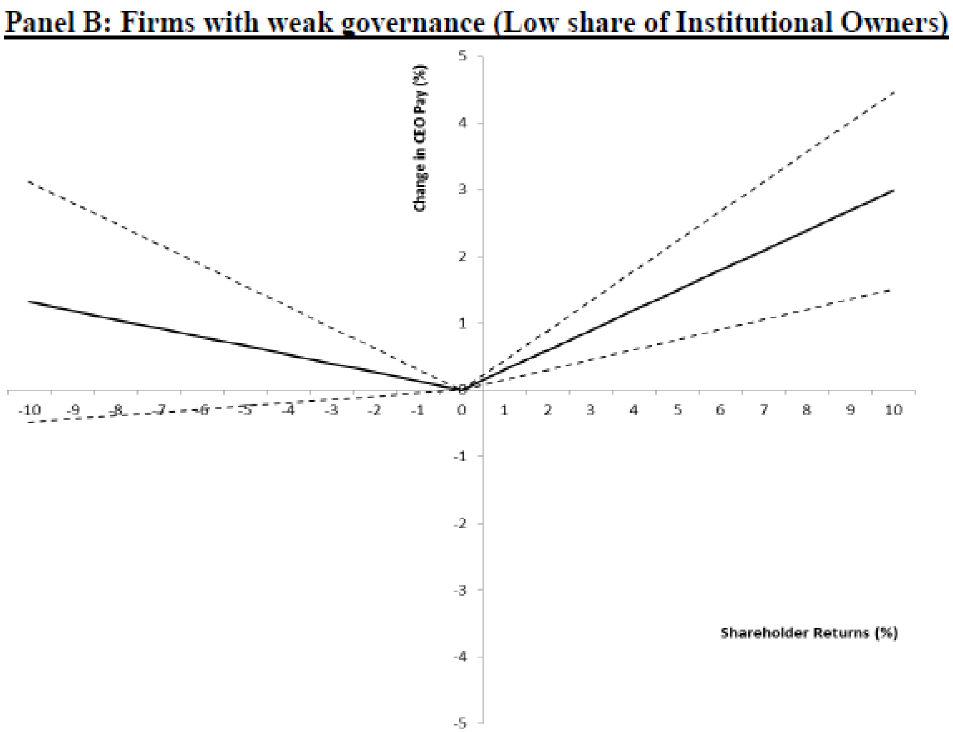
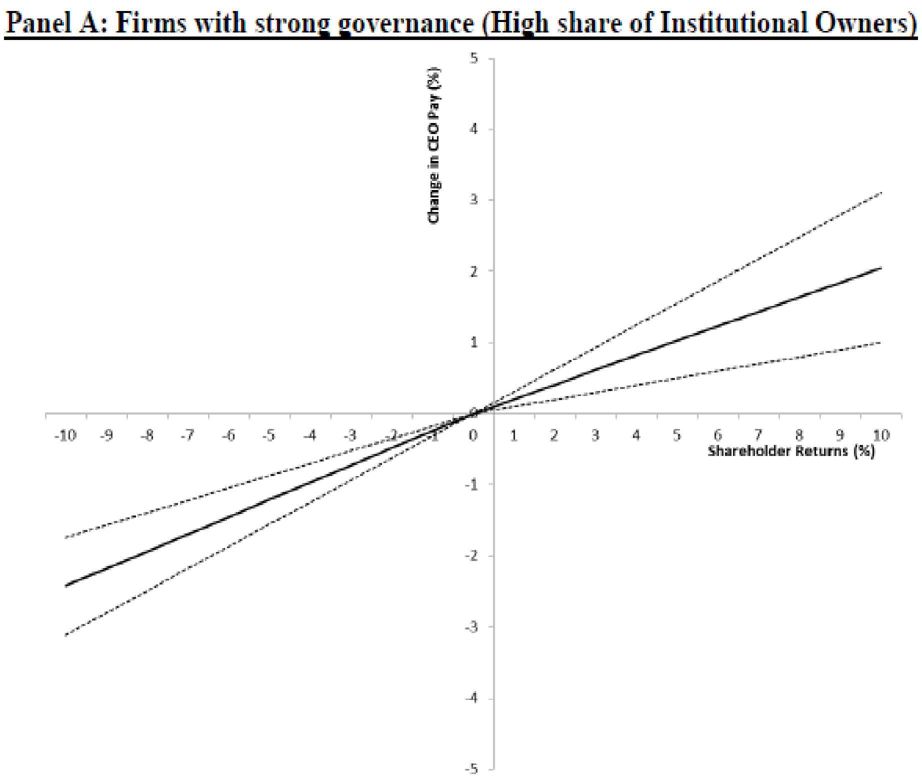
Corporate Governance Matters (Bell & van Reenen)





Corporate Governance Matters

- Bertrand and Mullainathan (2001)
  - Firms with better governance generally pay less for luck
  - «These effects are strongest for the presence of large shareholders on the board. An additional large shareholder on the board reduces pay for luck by between 23 and 33 percent. Large shareholders are especially important as CEO-tenure increases»
- Bell and van Reenen (2016)
  - Firms with a low share of activist institutional shareholders undo reduced payment due to bad performance by issuing larger equity shares to CEOs in subsequent years