Event Report: ‘Market or Racket: do we need a new approach to executive pay?’

Academic Introduction - Market or Racket?

Dirk Jenter, Associate Professor of Finance, London School of Economics

Dirk Jenter gave a keynote presentation primarily focused on levels of pay. He examined how high levels of CEO pay really are compared to their historical values, and potential reasons behind this.

Jenter began his presentation with an uncontroversial statement that CEOs are paid a lot of money. With pay packages reaching the millions, and at much higher levels than 40 years ago, CEOs are coming under fire from society including members of trade unions, activists, politicians, and journalists. This raises a number of important questions from an academic perspective: why are CEOs and other top executives paid so much, are high levels of pay justified, should executive pay be reined in and if so how?

Jenter presented data on how CEO compensation has developed over the past 80 years. He argued that despite the impression held by many that executive pay is “an ever-increasing juggernaut”, this is not necessarily the case when you examine the academic evidence. He analysed US data of the median pay of CEOs in the 50 largest publicly traded US companies going back to 1936. The data demonstrated three distinct phases of median CEO compensation; an essentially flat period from the 1930s to the 1970s, a sharp rise in the 1980s and 1990s, followed by a fairly flat period in the 2000s. Jenter also examined other types of data including CEO pay in S&P 500 companies from 1992 to 2014, and median CEO pay in the FTSE 100 from 2010 to 2018. With respect to the past decade, he found that a “sideways movement” of CEO pay is not just a US phenomenon, and has been seen in the UK and elsewhere also.

Jenter showed how analysis of the structure of CEO compensation of the 50 largest publicly traded firms from 1936 to 2005 provides insights into the evolving nature of pay packages. Jenter said the sharp rise in executive pay in the 1980s and 1990s was made up almost entirely of a rise in equity compensation. During this period, the salary and bonus component barely increased. The surge in CEO compensation over this period was due to an increase in options, which over the last 15 years have been gradually replaced by performance shares.

It can be challenging to compare executive pay at companies of different sizes across different countries and get a like-for-like comparison. Jenter utilised data from a study by Fernandes, Ferreira, Matos and Murphy to help him calculate the average CEO pay for a CEO in a company with $1 billion in sales, controlling for a number of differences. Jenter found that US CEOs earned the most, more than $2.5 million, versus a non-US international average of nearly $1.5 million. He saw that there were large differences in average CEO pay between Anglo Saxon countries, and more egalitarian countries in northern Europe such as France and Belgium where CEO pay was less than $1 million. Jenter also saw that companies from Anglo Saxon countries put more weight in equity-based compensation and long-term incentive pay, rather than salary.

The topic of executive pay has sparked contentious debate over the past 20 years, with different views to explain why executive compensation has increased and whether this rise is positive or negative. Jenter outlined two main camps of thought. ‘Camp one’ believes that executive pay is too high and is a result of governance failures. For ‘camp two’, high pay is the outcome of an efficient market process and is ultimately good for shareholders.
In their book, Lucian Bebchuk and Jesse Fried, key proponents of the ‘camp one’ view on executive pay, wrote that “CEOs control their boards of directors and maximize their own compensation, subject only to an outrage constraint.” Jenter interpreted this view as saying that executives are essentially stealing from shareholders, taking what they can get away with, but not pushing too far or they would face outrage from the public or shareholders or both. “I don’t buy it” Jenter asserted. In his view, if executives were indeed stealing from shareholders and this was the driver behind high executive pay levels, it would not be too difficult to rein in. The solution would be to empower shareholders, Jenter said. However, he noted that corporate governance has improved a great deal over the past 40 years with shareholders becoming more powerful, for example with the rise of activist investors, say-on-pay giving shareholders the chance to vote down pay packages, and improvements in legislation. Furthermore, Jenter also sees limited evidence that shareholders object to CEO compensation levels. He argued that private equity owned firms pay their top executives just as much as those in public markets. For Jenter, the ‘stealing’ view cannot explain the rise in executive compensation over the past 40 years. He acknowledged that there have been individual cases of very excessive pay levels that are difficult to justify, which contributed to the spike in the average S&P 500 company’s CEO pay in the 1990s. However, looking at the overall picture does not support camp one’s view, Jenter said.

An alternative view, held by ‘camp two’, is that high pay is efficient and good for shareholders. Under this interpretation, there is a competitive market for executives, with companies competing for their services and driving up their pay levels. Jenter said that the view here is that boards pay great sums for executives because they believe they will deliver and are worth the money. Jenter argued that if activists, academics or journalists pressure companies to hire an alternative CEO who is less expensive but also less effective in their role, this could ultimately end up lowering the firm’s value and having a worse outcome for shareholders. To critics who say that no CEO could be worth as much as $10 million, Jenter believes this is a “completely outrageous” and frustrating view. Jenter said that critics “need to work hard to make the case that packages we see are excessive or cannot be justified”. He argued that these pay levels can be easily justified, particularly for such large companies. Jenter explained that a typical firm in the middle of the S&P 500 has a market value of around $35 billion. If a CEO is able to increase market value by just 1%, this is equivalent to market value growth of $350 million. Therefore, if a board believes that candidate #1 is better than the next best candidate and could increase the company’s worth by 1% or more than company #2, you could easily justify a $10 million or $100 million compensation package.

In addition to a CEO being able to increase market value, Jenter put forward other reasons to justify high executive pay levels. Over the past 40 years firms have grown in size and complexity. Companies have grown larger. Jenter said that pay ratios versus company size have not changed much. CEO pay increased by a factor of six from 1980 to 2000, and so did firm size. However, Jenter stressed that firm size cannot explain all trends in CEO pay. Companies also grew during previous periods, from the 1950s to 1960s for instance, while executive pay did not increase. However, firms have become more complex with developments in information technology, which may have made CEO ability and talent more valuable. IT has expanded the CEO’s span of control and placed more demands on an individual to run a company, which has increased the need for a highly skilled and thus more valuable individual. Jenter reminded the audience that these are all potential explanations of why executive pay has risen, and that proving or disproving that these developments caused an increase in CEO pay is very difficult due to limited evidence.

A key aspect of the ‘camp two’ view is that the market for CEOs is highly competitive, with firms competing for extremely talented people and in the process driving up the market price for them. Jenter shared a concern that the market may not be as competitive as many believe. He observed from a current research project that firms tend to hire CEOs from a surprisingly small pool of
candidates. In S&P 500 firms over the last 20 years, more than 80% of new CEO hires are insiders, such as a current CEO or a former board member of the firm. More than 10% have worked with at least one of the hiring firm’s directors. Only 3% of new hires are poached CEOs of other firms. This leads to the conclusion that firms hire from a relatively small pool of people they are already familiar with and not in fact competing for CEOs.

In terms of the variation seen in CEO pay, particularly over the past 30 years, Jenter suggested that this may be due to CEOs’ ‘outside option’, i.e. what they could earn elsewhere. How much extra market value a CEO is able to bring, and earn themselves, varies, and therefore what companies and CEOs assess to be their worth. Jenter said according to economics principles, a fair level of pay is perceived to be in between two bounds – pay cannot be less than what the CEO can earn elsewhere, but it cannot be more than the value the CEO brings to the company compared to the next best candidate.

In a closing statement, Jenter warned that companies must find the right CEO at the right pay level, and to not go too low. He said that if companies are forced to choose a less preferred candidate at a lower pay level, they could lose a very talented executive with the ability to boost market value and end up doing an awful lot of damage.