CEO Pay – What do We Know?

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CEO pay

• CEOs (and other top executives) are highly paid
  ▪ Regularly criticized by activists, politicians, unions, and journalists

• Which raises several important questions:
  ➢ Why is pay so high?
  ➢ Are the high levels of pay justified?
  ➢ Should executive pay be reined in?
CEO pay: Level

- Median pay of US CEOs and other top officers from 1936 – 2005
  - 50 largest publicly traded firms in 1940, 1960, and 1990

CEO pay: Level

• Median CEO pay in the FTSE 100 from 2010 – 2018

• Source: CIPD and High Pay Centre

CEO pay: Structure

• The structure of CEO compensation from 1936 – 2005
  • 50 largest publicly traded firms in 1940, 1960, and 1990
CEO pay: International

- CEO pay in a firm with $1bn in sales

CEO pay: Facts

- CEO pay in the US
  - was flat from the 1930s to the early 1970s
  - rose rapidly from the late 1970s to 2000
  - has not changed for the typical CEO since

- The rise in CEO pay during the 1980s and 90s was almost entirely the rise of equity compensation
  - Options in the 1980s and 1990s
  - Options gradually replaced by performance shares in the 2000s
What does it all mean?

• What explains the rise in executive compensation?
  ▪ Is it good for shareholders?

• A contentious debate with two camps:
  ▪ Camp 1: High pay is the result of governance failures
  ▪ Camp 2: High pay is efficient and good for shareholders

What does it all mean?

• Camp 1: High pay is the result of governance failures
  ▪ Lucian Bebchuk (Harvard): “CEOs control their boards of directors and maximize their own compensation, subject only to an outrage constraint.”

☞ Executives are stealing from shareholders
  ▪ To rein in executive pay, empower shareholders
    ▪ More pay disclosure
    ▪ Say-on-Pay
    ▪ Proxy access
What does it all mean?

- Problem: Corporate governance, i.e., shareholders’ power vis-à-vis managers, has improved over the last 40 years, not worsened
  - 1980s: Hostile takeovers
  - 1990s: Activist investors
  - 2000s: Activist investors, board independence
  - 2010s: Activist investors, board independence, Say-on-Pay

⇒ The “stealing view” cannot explain the rise in compensation over the last 40 years
  - It explains “stealth compensation” and individual cases of excessive pay

What does it all mean?

- Camp 2: High pay is efficient & good for shareholders
  - There is a competitive market for managers
    - Boards pay a lot for executives because they are worth it
    - Hiring a worse CEO for less would reduce value by more than the pay savings
  - Easy to justify large pay packages
    - Market value of the typical S&P 500 firm ~ $35bn
    - If a manager can increase value by 1% ⇒ $350m
  - Limited evidence that shareholders object to CEO pay levels
    - CEOs in private-equity owned firms are paid no less
What does it all mean?

• **But:** How does this explain the rise in CEO pay since the 1970s?

• **Hypothesis: CEOs have become more valuable**
  - Changes in firm size and scale make CEO talent and effort more valuable
    - CEO pay increased by a factor of six from 1980–2000, but so did firm size (market value)
  - But: Firm sizes also increased in the 1950s and 60s – what changed in the late 70s?
  - Changes in firms’ complexity, information technology, and product markets may have the same effect
    - Information technology expands the CEO’s realm of control
    - Deregulated product markets raise importance of management

What does it all mean?

• **But:** How competitive is the market for CEOs really?

• **Evidence:** Firms hire CEOs from a surprisingly small pool
  - S&P 500 firms from 1992-2012:
    - >80% of new CEOs are insiders
    - >10% have worked with at least one of the hiring firm’s directors
    - Only 3% of new hires are poached CEOs of other firms

• Suggests that CEOs’ outside options <<< their contribution to firm value
  - Say firm worth £50m more under current CEO than next best manager
  - But CEO’s value-added in best alternative job is only £10m
  ⇒ What’s the “fair” level of pay? How are the £40m to be split?
Conclusion

• CEOs and other top executives are paid a lot, and a lot more than 40 years ago

• A good CEO can be worth a lot – 1% of $10bn is $100m
  ▪ CEO compensation, even though large, is a small percentage of firm value

• Economics suggests that CEO pay should be between
  ▪ Minimum: The CEO’s outside option
  ▪ Maximum: The CEO’s value added
    ➢ This might be a wide range