EXECUTIVE COMPENSATION AND SHORT-TERMISM

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Short-Termism in European Corporate Governance

SHORT-TERMISM?

CFA Institute

- What? *Excessive focus on short-term results at the expense of long-term interests*
- Impact?
  - *Increasing focus on quarterly earnings*
  - *Decreasing focus on strategy & long-term value creation*
  - *At the cost of: development of sustainable products, operational efficiencies, development of human capital, effectively managing social and environmental risks*

Does executive remuneration imply short-termism?

THREE-PARADIGM APPROACH TO EXECUTIVE COMPENSATION

Optimal contracting

- Make executives work in best interest of shareholders (solve principal-agent problem)
- Retain well-performing executives
- Pay-for performance, risk sharing, LT focus & transparency

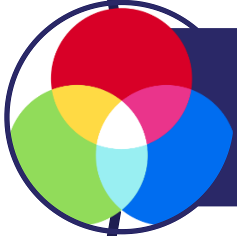
Rent extraction

- Board captive to executives - executives maximize own rents
- Sub-optimal contracts
- Agency costs, lack of transparency, board capture, Short-term focus

Institutional theory

- Institutional influences:
  - Accounting rules
  - Disclosure guidelines
  - Proxy advisors
  - Peer groups & consultants

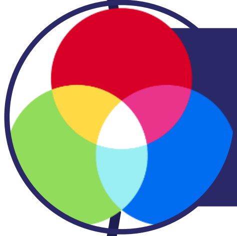
Remuneration level



Remuneration structure

Remuneration criteria

Remuneration level



Remuneration structure

Remuneration criteria

CEO – BOARD DYNAMICS

CEO tenure → CEO power → CEO remuneration

An additional year of CEO tenure is associated with a 2,4% increase in annual remuneration

- Decrease in % independent directors
- Less likely to be replaced in case of poor firm performance

Graham, Kim, Leary

THE IMPACT OF TWO TYPES OF CEO OVERCOMPENSATION ON CORPORATE SOCIAL RESPONSIBILITY

CEO internal overcompensation (-)

CEO external overcompensation (+)

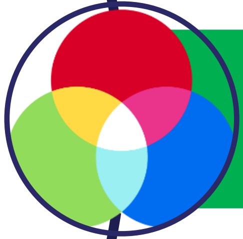
→

CSR performance

- **Internal overcompensation** (difference CEO-TMT)
  - Overconfidence
  - Prioritisation of short-term career goals
- **External overcompensation** (CEO vs. other CEOs in the industry)
  - Established reputation of good financial performance
  - Decisions against CSR might threaten reputation as successful leader

Jeong

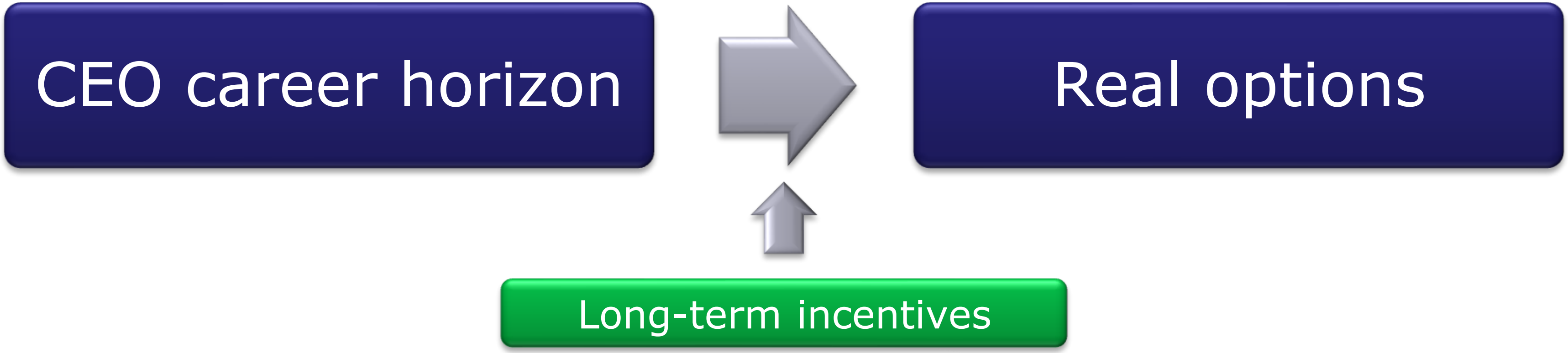
Remuneration level



Remuneration structure

Remuneration criteria

CEO CAREER HORIZON, CORPORATE GOVERNANCE, AND REAL OPTIONS: THE ROLE OF ECONOMIC SHORT-TERMISM



- When decision-makers have less **time before exercising options**, they have less flexibility and the value of the real options portfolio will decrease
- CEOs with longer **career horizons** are unaffected by LTI, but short-termism of CEOs with shorter career horizons will be mitigated by the presence of LTI
- E.g., long **holding periods** of RSU => more investment projects with long-term payoffs

Lee, Park, Folta

RESEARCH BY EXECUTIVE REMUNERATION RESEARCH CENTRE

CEO remuneration structure

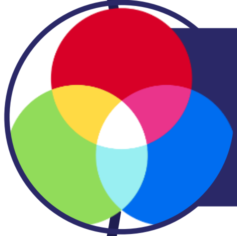
- **Incentive proportion (STI + LTI):**
  - ✓ >300% base pay in incentives is associated with lower performance than group until 100%
- **Proportion LTI:**
  - ✓ Negative

RESEARCH BY
EXECUTIVE REMUNERATION RESEARCH CENTRE

CEO remuneration structure

- **Long term incentives:**
  - ✓ Positive: performance shares + long(er) vesting period
  - ✓ Negative: grant size (100-180% = danger zone)

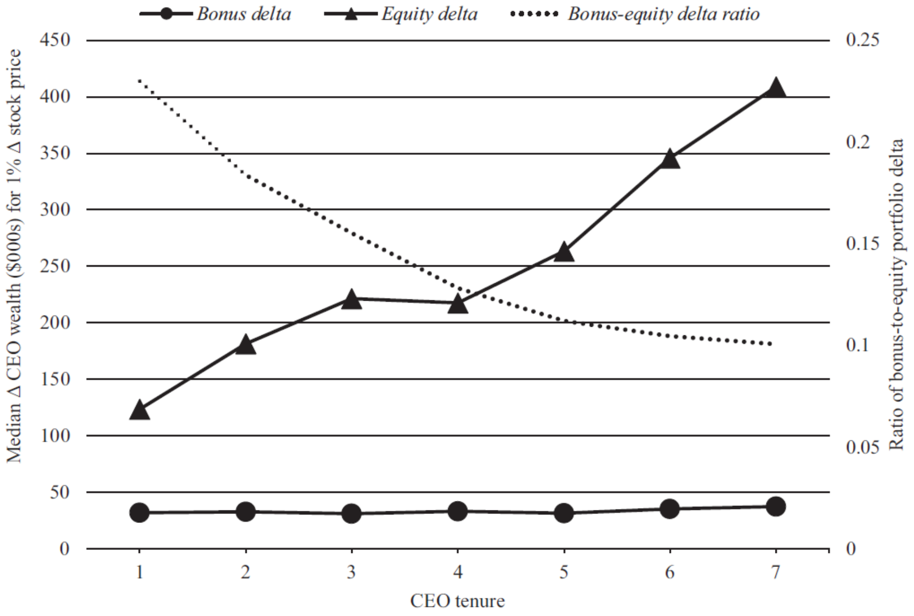
Remuneration level



Remuneration structure

Remuneration criteria

THE ROLE OF EXECUTIVE CASH BONUSES IN PROVIDING INDIVIDUAL AND TEAM INCENTIVES



- **Bonus delta** = sensitivity of bonus to change in earnings
- **Equity delta** = sensitivity of stock portfolio to change in stock price
- Early career: balanced mix between cash- and equity-based pay
- Later in career: financial incentives arise much more from equity portfolio

Graham, Kim, Leary

ARE INCENTIVE CONTRACTS RIGGED BY POWERFUL CEOS?

CEO power → Rigging → Firm performance

to arrange dishonestly for the result of something

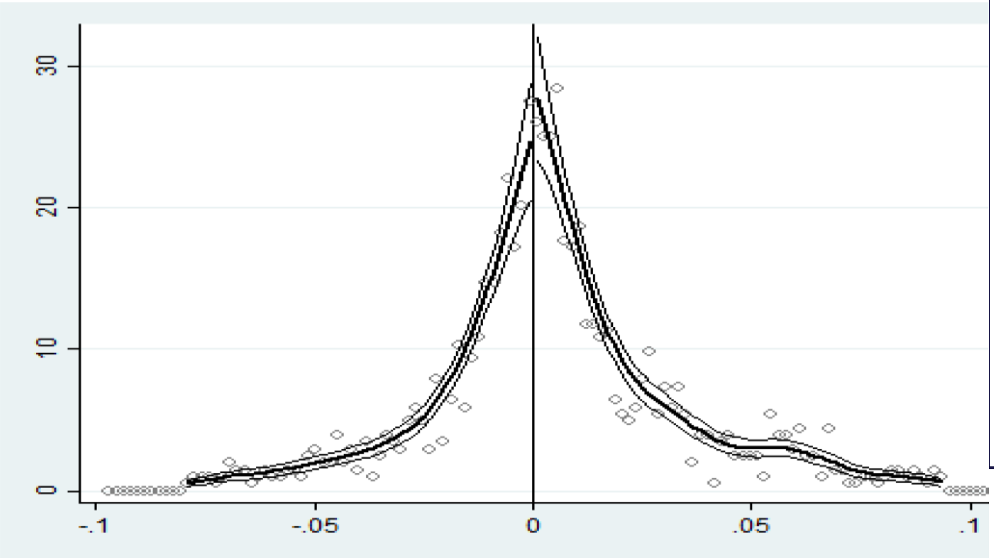
Cambridge Dictionary

- A firm with a one standard deviation above mean rigged incentive pay faces a 4,8% decrease in firm value, a 7,5% **decrease in operating return on assets**
- Pay of powerful CEOs has greater **sensitivity to the better performing** of stock returns and return on assets in a given period
- => Need for greater **ex ante disclosure** of CEO incentive contracts/KPIs

Ostensibly performance-based pay

Graham, Kim, Leary

COMPENSATION GOALS AND FIRM PERFORMANCE



- Disproportionally large number just **exceed goals**
- **Stronger effect** in case of single metric, concave kink at target, non-equity payout
- How to **solve**?
  - Not identifying specific performance targets
  - Specify goals relative to other firms
  - Avoid EPS

Bennett, Bettis, Gopalan, Milbourn

EXECUTIVE REMUNERATION CRITERIA

CEO remuneration criteria

- **Long term incentives:**
  - ✓ Negative: return-based KPIs
- **Incentives (STI/LTI):**
  - ✓ Negative: TSR
  - ✓ Positive: Accounting

EXECUTIVE REMUNERATION CRITERIA

CEO remuneration criteria

- Short-term incentives:
  - ✓ Strategy +, sales -, accounting -
- ✓ Long-term incentives:
  - ✓ LTI: TSR -, accounting + (gross profit), customer +

CONCLUSIONS

SUBOPTIMAL CONTRACTING/SHORT-TERMISM? AN EXECUTIVE REMUNERATION LENS

CEO characteristics	Board characteristics	Executive remuneration policies
• CEO tenure • Career horizon	• Insiders in board • Board members appointed after CEO	• Internal overcompensation • Incentive proportion • LTI design • STI-LTI balance • KPIs (e.g., EPS, TSR)