

Discussion of “Empirics of CEO compensation: What determines CEO pay?” by Stanimir Morfov and Manuel Santos

Bart Taub
Glasgow University

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Opening remarks

Theory

Estimation

Comments and suggestions

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Fat cats

A general observation: if the reports in the media are true, then CEOs are getting paid big salaries and perks for doing little work, and getting paid even when their firms are performing poorly.

How would one rigorously test this assertion?

Also, as a shareholder you would also care about this: you would want to

- hire the most talented CEO (adverse selection)
- give him incentives to work hard if you are not able to fully monitor his activities (agency)

Testing the fat cat idea

If CEOs are getting paid fat salaries and perks for doing little work, and getting paid even when their firms are performing poorly, then

- run a regression with a performance variable (returns)
- if the press reports are true, the constant terms in the regressions would be significant and the performance coefficient would not be positive and significant, and the R^2 would be low
- in most of the regressions in this paper the constant term is not significant and the performance coefficients are significant and positive

So the paper provides evidence that the media critics are wrong

Nice things about the paper

Sensible view that familiar elements affect pay:

- returns driven by systematic (i.e. market-correlated) factors; however on theoretical grounds not clear that this should cause fluctuations in pay for a qualified manager
- idiosyncratic (firm-specific) returns— any incentive and talent effects would show up here—outperforming the market should generate rewards and vice versa
- average CEO pay: this reflects basic managerial qualifications
- market share—increases also reflect outcomes of extra talent or effort

The authors find significant positive impact of all of these factors

The theoretical model

Risk-based pay:

- Firm minimizes wage cost:

$$\alpha + \beta\mu(\text{talent}) + \beta^2\sigma^2(\text{talent})$$

(Risk-based pay is costly)

- Payoff for CEO:

$$\alpha + \beta\mu(\text{talent}) - \beta^2\sigma^2(\text{talent})$$

CEOs are risk-averse, so negative in risk, but risk-return tradeoff improves with talent so talented CEOs apply for risky jobs and the damp squibs don't—this achieves separation

- β not the CAPM beta— systematic and idiosyncratic outcomes not separated

Motivating the empirical model from the theoretical model

The literature focuses on RPE (relative performance evaluation): pay should be positively keyed to firm performance that is due to CEO; analogous with paying fund manager based on outperforming the market?

Implications of this for regression model: pay for firm-specific returns should be positive after controlling for “base” pay for systematic returns

The regression model attempts to get at RPE by holding fixed market effects (systematic return and average CEO pay) whilst including RPE variables (idiosyncratic returns and market share changes)

Motivating the empirical model from the theoretical model

How is this driven by the adverse selection model?

- The adverse selection model assumes you rehire CEO in every period, without regard to realized past performance
- The empirical model does not seem to test whether CEOs actually do separate, because the non-hires are not in the sample—rather, it assumes the model is correct and shows that risk-based pay is used in practice

Data issues

Observations in which there is no equity-based pay dropped (23% of the sample)—sample selection bias?

(The authors estimate an extra regression in which they add a small amount to zero equity and then include these omitted observations; the results don't change much)

Suggestion: address this sample selection issue more broadly in the regressions

Suggestions

Discuss data source and estimation procedure for estimating systematic and idiosyncratic return—if estimated, how does this interact with estimation of the model?

Other suggestions

The model asserts that higher volatility pay (i.e. equity-based pay) attracts higher-talent CEOs

Perhaps you could calculate the realized volatility of pay for CEOs, and connect firm performance to this in order to detect talent; specifically,

- Are higher long-run returns (higher alphas), which might be due to talent, associated with *subsequent* higher-volatility pay?
- This must be squared with the fundamental CAPM market-line predictions

Other suggestions

For equity-based pay (options), option value is positively driven by volatility, the CEO has an incentive to increase volatility; how does this affect the model and the regressions?

Dynamics?

The R^2 statistics are low, suggesting that there are other forces determining CEO pay

Could *dynamic* effects be part of the explanation for this?
decoupling—see my Rand J. paper

Intuition for the decoupling result:

- Action is unobservable (agency)
- Rewards include direct payoff but also promises of future payments (continuation value)
- Rewards are thus spread out over time
- Consequence is that an outside observer would not see performance and pay temporally coupled

Dynamics continued

Examining Table 3, which looks at basic regression for each of the years in the sample:

- In 2008-2009, which were major-recession years, sensitivity to idiosyncratic returns falls: these are the years when the press noticed that CEOs were getting paid high salaries despite the poor performance of their firms
- Concomitantly in 2003-2006, sensitivity is higher, even though firm returns were mostly due to systematic positive shocks
- Decoupling is a potential explanation

