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## DOES EXCESSIVE EXECUTIVE COMPENSATION REALLY PAY SHAREHOLDERS?

Emre Ergin, Kocaeli University, Turkey

### ABSTRACT

*The issue of executive compensation is controversial. Executive compensation is viewed as a solution to align the interests of owners with those of agents. However, instead of solving the problem, the pay mechanism aggravates the agency problem. Although there is an upward trend in the salaries of executives, excess money paid to executives does not ensure high returns to shareholders. First, this paper discusses the reasons for the executive pay rise. Then, the research examines the link between the executive compensation and financial performance from a market perspective. Banks quoted on the Istanbul Stock Exchange (ISE) in the four-year period 2006-2010 were analyzed using a price model. The results show that the regression coefficient for the executive compensation is significantly different from zero and negative. It is concluded that the executive compensation system is not designed towards shareholders' value maximization.*

**Keywords:** *Executive compensation, financial Performance, banks, ISE, Turkey.*

### INTRODUCTION

The conflict of interest between shareholders and managers has been known long before. Berle and Means (1932) argued that managers must be controlled in order to avoid losses. According to Adam Smith (1937), managers cannot watch partner's money with the same vigilance with which partners watch over their own so the negligence and profusion, therefore, must always prevail in the management of affairs of a company. Jensen and Meckling (1976) modeled this situation as an agency relationship and defined it as a contract in which the principals engage the agent to perform some services on their behalf. Pay mechanism is considered one of the methods to reduce this conflict of interest. However, executive compensation has become a controversial issue as pay-for-performance relation is ambiguous.

An upward trend is witnessed in the salaries of managers. The base salaries and bonuses of Forbes 800 CEOs increased from an average of \$700.000 in 1970 (in 2002-constant dollars) to over \$2.2 million in 2000 (Murphy and Zabojnik, 2004). The increase continued until 2008 when the global financial crisis started. This trend is partly explained by the fat cat theory used by the media. A similar hypothesis explains that managers with power (also known as "entrenched CEOs") use captive board of directors to arrange for themselves large increases<sup>2</sup> in pay at the expense of companies' shareholders (Bebchuk et al., 2002). As the base salaries and other



benefits are negotiated between the CEOs and the board of directors, the terms of the contract are not submitted to shareholders for approval. The termination benefits are also costly for shareholders. To name a few, Morgan Stanley paid \$113 million to Philip Purcell in 2005; ExxonMobil paid \$400 million to Lee Raymond in 2006; Home Depot paid \$210 million to Bob Nardelli in 2007; Carrefour paid €38 million to Daniel Bernard in 2005. As for the latter one, the shareholders of Carrefour reacted to this payment and the Court of Appeal canceled the payment in 2008 based on the French 2005 Law to Promote Confidence and Economic Modernization (the Breton Law). This law increased the amount of information on executive compensation to be provided to shareholders, and set up some shareholder control over such compensation and penalties for non-compliance, for the first time. Another example of payment that was litigated is that of Richard Grasso, ex-chairman of the New York (NY) Stock Exchange, who resigned in 2003 due to the storms occurring after the announcement that he would receive a compensation of \$140 million. He was sued by the Attorney General of NY, alleging that Grasso's compensation was unreasonable, especially for a non-profit organization (Conyon, 2011). The lawsuit against Grasso continued for five years. Although in 2006 the NY State Supreme Court issued a decision, ordering Grasso to repay a significant amount of excess compensation, in 2008 the NY State Court of Appeals dismissed all claims against Grasso. In order to improve transparency in the financial system, on July 21, 2010, President Obama signed the Dodd-Frank Act which implements a number of significant regulations regarding accountability and executive compensation.

Financial scandals as observed at Enron, World.com and İmar Bank<sup>3</sup> in the 2000s and the need to inform shareholders shifted the attention to corporate governance in Turkey as well. As of January 01, 2012 regulations to limit and disclose the pay of the top management are to be effective.

This study aims to investigate the pay-for-performance relation in Turkey. The research sample of this study is the banks quoted on the ISE. The banking sector is important for the Turkish economy, which is the 17<sup>th</sup> largest gross domestic product and 3<sup>rd</sup> fastest growing economy in the world according to 2010 data. Among the ten biggest global crisis, the 2001 crisis that occurred in Turkey ranked 7<sup>th</sup> by witnessing the failure of more than 20 banks.

This paper contributes to the literature in several ways. First, it discusses the arguments that favor the increase of executives pay level. Secondly, it conducts an empirical research to test the agency theory for a very crucial sector, which is banking. Finally, it provides empirical results that would be useful for linking executive compensation package to firm performance.

## LITERATURE

The economic theory of executive compensation is the principal-agent contract (Ross, 1973). The contract approach is standard in the accounting, finance and economics literature. It asserts that firms design efficient compensation to solve moral hazards and to motivate

executives (Conyon and He, 2011). Shareholders elect the board which sets the executives' compensation for the mutual benefits of managers and shareholders. Agency theory predicts that executive pay will be positively correlated to firm performance. However, there is no real consensus on the relationship between executive pay and firm performance (Florin et al., 2010).

Executive compensation is different from compensation for lower-level employees. The former one is negotiated between the potential executive and the employer, which is often the board of directors. It often includes base salary, bonuses, stock options, additional executive-only benefits, incentives, perquisites, income protection guarantee in case of a sale or liquidity, and a guaranteed severance package (known as "golden parachutes") in the instance of a termination contract. The assessment of the optimum compensation is problematic since many subjective factors influence its terms. The contract is signed with the expectation that the executive will perform his best. However, the performance of the firm, which is a reflection of that of the executive, may disappoint shareholders. When the payment becomes unreasonable from the point of view of shareholders, the compensation is said to be excessive. This may result either by a failure to match compensation to the needs (in this situation the compensation is wasteful and unlawful) or by a poor judgment (Murrey, 2005) at the expense of the firm and shareholders' interests. Moreover, asymmetric information exists between shareholders and executives who may manage earnings. For instance, empirical evidence shows that incoming CEOs decrease net income of their starting year (Latif et al., 2011; Geiger and North, 2011), or debt issuance (Pae and Quinn, 2011). Thus, it becomes hard for the board of directors and shareholders to properly assess the true performance of the executives.

### **The origin of the term executives and the problem**

Although the first known use of the term "executive" dates back to 1774, its usage meaning the "businessman" dates back to 1902. In the modern sense of the term, "executives" mean individuals who are not owners of firms but those who manage large corporations on behalf of passive dispersed owner-shareholders<sup>4</sup>. Until the turn of the twentieth century, founders (or founders' descendants) and/or big owners directed most of the large corporations. The "Great Merger Movement" that occurred between 1895 and 1904 witnessed more than eighteen hundred small manufacturing firms consolidate into 157 large corporations. Senior management positions, once held by proprietors, were transferred to non-owner, salaried executives. This shift of senior managerial position to non-owner executives brought about the modern problem of executive compensation (Wells, 2010).

### **The increase of executive compensation**

Top executive pay has increased enormously over the past three decades (Minnick et al., 2011). Today, the ratio of average firm CEO pay to that of the average employee is around 400

in the United States, 22 in Britain, 20 in Canada and 11 in Japan (Hindery, 2008). In theory, the level of executive pay increases for one basic reason, which is to maximize shareholder value. However, the public criticizes highly paid executives, and stakeholders go to the limit of protest when the desired firm performance is not achieved. In practice, different arguments partly explain the rise of executive compensation.

### **Managers with power**

Some managers may be more powerful due to different factors (Bebchuk, 2002) and take profit from their power to increase their pay. Some circumstances may give power to managers: anti-takeover protection, mostly in the form of golden parachutes, is accorded to CEOs; entrenched CEOs use captive board of directors to arrange for themselves large increases in pay at the expense of firm's shareholders<sup>5</sup>; CEO compensation is positively related to the CEO stock ownership, hence, the share ownership increase gives CEOs more bargaining power; the lack of institutional investors or a large shareholder increase the power of managers to extract rents through compensation.

### **Size effect**

Studies show that the size (in terms of total turnover, total assets or operating profit) of the firm matters in shaping the compensation package. The bigger the size of the firm is, the bigger the pay of the executives is. (Murphy, 1999). Pay expectation of the executives increases parallel to the size of the firms.

### **Compensation packages with high-powered incentives**

Due to the globalization wave and technological developments that took effect after the 1990s, firms faced increased competition in the business environment. Offering attractive incentives is one of the means of hiring high-qualified leaders. That is why the variable part of a CEO's salary has become a few times more than his base salary.

### **The relative size of the executive pay**

The absolute amount of the executive pay is considered much higher than an average salary or a minimum wage of an employee. The number of executives is quite few in a large corporation where the number of total employees is usually more than tens of thousands. The leaders should be differently remunerated as far as the amount of executive compensation is tolerated in the corporate budget.

## RESEARCH

This paper analyses whether the benefits paid to top management is worth vis-à-vis shareholders. According to agency theory, a positive association is expected between executive compensation and firm performance.

### Sample

The study focuses on the Turkish banking sector because not only the sector is a critical one as the recent history<sup>6</sup> proves but also the executives are the most criticized ones as fat cats. There are 17 banks quoted on the ISE. The data set comprises the 2006-2010 years for the banks that disclosed the executive compensation information.

### Research design

In order to investigate the relationships between the executive compensation and the financial performance of the firms, an adapted version of the model used by Cazavan-Jeny and Jeanjean (2006) is used in equation (1) below:

$$P_{jt} = \alpha_0 + \alpha_1 BVE_{jt} + \alpha_2 NI_{jt} + \alpha_3 LN(EC_{jt}) + \varepsilon_{jt} \quad (1)$$

where  $P_{jt}$  is the share price of firm  $j$  at time  $t$ ,  $BVE_{jt}$  is the book value of equity of firm  $j$  at time  $t$ , divided by the number of shares outstanding at time  $t$ ,  $NI_{jt}$  is the net income of firm  $j$  at time  $t$ , divided by the number of shares outstanding at time  $t$ ,  $LN(EC_{jt})$  is the natural logarithm of executive compensation paid by firm  $j$  at time  $t$ , and  $\varepsilon_{jt}$  is an error term. A logarithmic transformation is used for executive compensation to make variation constant across levels of the series to deal with heteroscedasticity.

This model relates share price to book value of shareholders equity ( $BVE_{jt}$ ) and current net income ( $NI_{jt}$ ). The effect of executive compensation to stock price is tested by regression coefficient  $\alpha_3$ . This coefficient should be positive and significantly different from zero.

In the executive pay performance literature, both market-based measures and accounting-based measures are used. Accounting-based measures of firm performance reflect past information. In market-based measures, investors discount expected future performance in determining the stock price. Thus, the selection of performance measure is important (Laan et al., 2010). Most researchers select the performance measures from the accounting data such as the return on assets, earnings before interest and taxes, and earnings per share. In this study, performance measure, the dependent variable, is selected from a market-based approach.

## Findings

Besides the variables included in equation (1), Table 1 presents descriptive statistics of executive compensation (EC) and market value (MV) as well. All amounts in Table 1 are in Turkish Liras (TL) and are to be multiplied by 1.000.

Table 1

| Descriptive Statistics |           |            |           |         |            |
|------------------------|-----------|------------|-----------|---------|------------|
| Variables              | Average   | Std.Dev.   | Median    | Minimum | Maximum    |
| MV                     | 9.554.323 | 10.309.391 | 3.080.000 | 436.000 | 34.320.000 |
| BVE                    | 5.574.850 | 5.670.654  | 1.941.667 | 434.708 | 18.986.655 |
| NI                     | 1.039.067 | 1.108.709  | 267.904   | 2.742   | 3.401.986  |
| LN(EC)                 | 9,4       | 1,0        | 9,5       | 6,8     | 11,5       |
| EC                     | 20.295    | 22.483     | 13.348    | 881     | 100.075    |

*Note.* n=42. MV is the market value of the firms quoted on Istanbul Stock Exchange. BVE is the book value of equity. NI is the net income. LN(EC) is the natural logarithm of the executive compensation (EC). All of the values are in Turkish currency and are to be multiplied by 1.000.

The average firm market value was TL9.554.323, the average book value was TL5.574.850 and the average net income was TL1.039.067. The results indicate that the sampled firms are relatively important ones in the Turkish market. The average executive compensation is TL20.295 where the minimum is TL881 and the maximum is TL100.075.

Table 2

| Correlation Between Variables |        |        |        |
|-------------------------------|--------|--------|--------|
| Variables                     | BVE    | NI     | LN(EC) |
| MV                            | 0,802* | 0,800* | -0,118 |
| BVE                           |        | 0,855* | 0,009  |
| NI                            |        |        | 0,205  |

*Note.* n=42. \* represents significance at the 0.1% level (one-tailed test).

Table 2 presents the Pearson correlations among test variables. The largest and significant correlations are between MV, BVE and NI variables. Executive compensation has a negative correlation with market value and is not statistically correlated with other variables.

The results of the estimation of equation (1) are shown in Table 3. The adjusted  $R^2$  for Model 1 indicates that the independent variables, book value of equity ( $BVE_{jt}$ ) and net income ( $NI_{jt}$ ), explain 84 percent of the stock price variation. When adding executive compensation,  $LN(EC_{jt})$ , the adjusted  $R^2$  of Model 2 is only 1,9 percent higher than that of Model 1. The coefficient of  $LN(EC_{jt})$  is significantly different from zero. As predicted, EC alone has given a very small number close to zero, so the distribution of log-transformed EC is closer to normal than EC, and the linear regression model works better with normal variables. However, the sign of the  $LN(EC_{jt})$  coefficient is negative, contrary to positive prediction, which shows that the direction has a negative relationship.

Table 3

## Models

| Variables      | Model 1 | Model 2  |
|----------------|---------|----------|
| BVE            | 1,25 *  | 0,81 *** |
| NI             | 4,14 ** | 5,98 *   |
| LN(EC)         | -       | -0,82 *  |
| Constant       | -0,55   | 7,48     |
| Adjusted $R^2$ | 0,84    | 0,86     |
| F-Statistics   | 57,48   | 36,55    |

Note . \*, \*\*, \*\*\* represent significance at the 1%, 5%, and 10% levels, respectively.

The variance inflation factors (VIF) of BVE, NI and LN(EC) are 4,17, 4,35 and 1,17 respectively. Having VIF more than 2 is an indication of multicollinearity problem, values greater than 10 is an indication of serious multicollinearity problem. The condition index of BVE, NI and LN(EC) are 3,7, 10,3 and 28,9 respectively. When the value of condition index is greater than 30, it indicates a strong multicollinearity problem. The results show no serious multicollinearity problem. When the executive compensation increases, empirical results show that the wealth of shareholders is transferred to management, causing a negative impact on the share price. Agency theory predicts that executive pay is positively correlated to firm performance. The empirical results fail to establish a positive relationship. Entrenched executives and the lack of compensation committees to prepare an optimum contract are the possible answers for this negative relationship. The board of directors should review the executive compensation system to maximize shareholders' value.

## CONCLUSION

Executive compensation is viewed as a solution to agency problem between shareholders and managers. It is argued that firms compensate their executives so that they accomplish the firm's goal, which is the shareholder value maximization. However, huge pay packages create worldwide discomfort among shareholders and are, therefore, criticized globally. Agency theory predicts a positive relation between executive compensation and shareholder value. In practice, this positive link is not clear. The objective of this study is to test agency theory for the relationship between executive pay and firm performance. The data set consists of all the 17 banks, quoted on the ISE for the period 2006-2010.

The results of this study show that there is a negative and statistically significant relationship between executive compensation and firm performance. Empirical evidence suggests that the executive compensation mechanism is not designed to increase shareholders' maximization in the ISE banking sector. It is believed that executive compensation should be linked to the firm's success. It is both the responsibilities of the authorities and the board of directors to protect shareholders' interests. Executives should be compensated according to a pay-for-performance plan.

## ENDNOTES

1. "Fat cat" is a concept used to describe executives who earn what many believe to be unreasonably high salaries and fringe benefits. These top executives also receive generous pensions and retirement packages, consisting of extra compensation not available to other employees in the firm. This term conjures up the image of cats that consume more than an appropriate amount of food and become grossly overweight. In the United States, publicly-traded companies are required to disclose the amount of compensation that their top five executives receive. As a result, companies have been under a lot of scrutiny for excessive executive compensation, especially in the face of floundering revenues. A real-life example of a fat cat would be the former Disney CEO, Michael Eisner. For a period of five years in the late 1990s, Eisner received over \$737 million in compensation, despite the fact that the firm's five-year net income reduced an average of 3.1% each year. (<http://www.investopedia.com/terms/f/fatcat.asp>, Accessed 21.03.2011).
2. Bebchuk et al. (2002) have defined these large increases as "rents" that are value in excess of which managers would receive under optimal contracting.
3. The Imar Bank scandal was one of the greatest banking corruption cases in the Turkish Republic, and the sum of the fraud amounted to \$7.2 billion. This amount is even greater than that of Société Générale Bank scandal in which the bank lost €4.9 billion.
4. Contrary to this definition, some people on the board or at the top management positions, irrespective of being an owner or managing a small firm, may call themselves executives. This misuse of the term is done in order to attach more importance to themselves and their firm.
5. See Murphy and Zabojnik (2004:192-193) for a counter argument of this assertion.
6. The total number of banks operating in Turkey is 49, down from 81 by the end of 1999.

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