

Do Institutional Investors Pay More Expensive Salaries?

Lukas Meier*

Master Thesis in Banking & Finance



**University of
Zurich^{UZH}**

Institute for Banking & Finance

Prof. Alexander F. Wagner, Ph.D.

Dr. Christoph Wenk

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Abstract

This paper aims to measure the institutional influence on the compensation of firm executives. Moreover, we test if it makes any difference whether subjective values for compensation are used instead of market values. We find that the percentage of shares held by *all* institutional owners of the firm is negatively related to the total overall executive compensation, while no significant effect on pay packages exist. The institutional ownership *concentration*, however, is positively related to the total overall executive compensation and negatively related to the equity-based and variable compensation. Further, we observe that our results do not significantly change with subjective values for compensation.

Executive Summary

Problem

Although executive compensation has become a controversially discussed topic in the recent past, the actual reasons for the level and the composition of executive compensation were predominated by the popular outrage. It is clear that the executive compensation is mainly driven by common factors such as the executive skills, the firm performance, the firm size, or the managerial control rights. However, theoretical research shows that shareholders may play an important role in compensation decisions.

In this thesis we aim to identify a relation between institutional investors and executive compensation in the largest hundred Swiss companies. We do not only test whether institutional investors influence the level of compensation, but also whether they affect pay packages. As a measure of executive pay, we use both market and subjective values for compensations, which include equity-based pay. We focus our analysis on Switzerland due to the current developments in terms of shareholder rights and because institutional investors play a major role in Switzerland-based companies.

Method

To answer the question whether the level and the composition of compensation is affected by institutional investors, we identify firm characteristics that certainly influence executive compensation and calculate institutional influence measures following the suggestions of Hartzell & Starks (2003). We use two different models to test the relation between institutions and compensation. First, we employ a standard clustered ordinary least squares regression using the identified firm characteristics as control variables. Second, we conduct a two stage approach that predicts an expected salary based on the observed firm characteristics in the first stage. In the second stage we calculate the abnormal compensation for each company and year and test the relation to institutional shareholders.

Following the approach of Hartzell & Starks (2003), we use two different measures of institutional influence. First, the percentage of shares held by all institutional owners of the firm is an obvious measure. However, it does not reflect the power of each institutional shareholder adequately. Shleifer & Vishny (1986) show that the size of the institution's share plays a major role in corporate governance. They show that the larger an institution's share is, the more active it uses its influence. Based on these findings, we use two diverse concentration measures for institutional ownership to take their power into account: The percentage held by the top five institutions as a share of the total institutional ownership and the firm's Herfindahl Index of

institutional ownership.

In addition to disclosed market values of compensation in the annual statements, we calculate subjective values in order to account for the fact that stock or stock option compensation is worth less to a manager than to another investor. On the one hand, the lower value comes from the risk aversion of the managers and on the other hand from the underdiversification. A manager is often explicitly or implicitly forced to hold a certain share of his wealth in the company stock and thus, is unable to perfectly diversify his wealth. We calculate cash equivalents that the manager would accept instead of pay packages containing stock or stock option grants. We use the approach of Ingersoll (2006) to calculate subjective values.

In our analysis we cope with a range of other factors in order to isolate the effect of institutional ownership. We use controls such as the firm size, the growth opportunities, and the board size. Additionally, we account for the firm performance in the current and previous year, since this is expected to be the main influential factor on the (variable) compensation. Also, we control for the domicile of the shareholders. This alleviates the concern that foreign investors may not be perfectly aware of the organization structure of Swiss limited companies or simply have different views on executive compensation.

Results

Three central findings are described in this paper. First of all, we find a *positive* relationship between the institutional investor concentration and the total overall compensation. This is against our hypothesis. Since it is beyond controversy that (large) institutional investors reduce agency costs, we would have expected lower managerial control rights with large shareholders (Shleifer & Vishny, 1997) and thus, a lower total overall compensation.

Second, institutional investors grant *less* equity payments. This is consistent with our hypothesis. Due to risk aversion of the managers and the possible abuse of equity and stock option grants, the managerial incentive compensation is costly. Since large shareholders are capable to closely observe executive behavior, aligning the manager's with the shareholders' interests becomes less relevant. (Shleifer & Vishny, 1986; Huddart, 1993)

Finally, we observe the variable part of compensation to be *lower* with higher institutional investor concentrations. We hypothesize a higher variable compensation compared to the base compensation, since a closer observation of the management allows to better assess the executive's performance and condition the salary on actual effort more appropriately (Shleifer & Vishny, 1997).

Across various regression specifications, a one percent increase in the institutional ownership concentration is associated with about 0.5% higher total overall executive compensation. This is

an increase of approximately 70'000 Swiss francs in the total overall compensation for an average executive board in 2012. Furthermore, a one percent increase in the institutional ownership concentration leads to a decrease of about 0.2% in the equity to cash compensation ratio for an average executive board in 2012. Finally, the variable to base compensation ratio declines also by about 0.2% with a one percent increase in the institutional shareholder concentration.

Additionally, our results hold for both the standard clustered OLS model and the two stage abnormal compensation approach. Hence, the change of an absolute to a relative measure does not change our results. Also, if subjective values of compensation are used instead of market values, the main findings remain the same. In fact, this is because institutions' and normal investors' preferences for firm characteristics that affect subjective values (e.g., stock variance) are mostly in line. Even if the models are employed for each year or industry separately, we do not observe drastically deviating results. However, because of the relatively small sample size with only hundred corporates categorized into ten industries, the results lack expressiveness.

Evaluation

Our three main findings are controversially supported in the published literature. We put our results in the context of four important insights in the literature. First, our results contradict the findings of Hartzell & Starks (2003) to the extent that the two scientists showed that the institutional ownership concentration is *negatively* related to the level of compensation and *positively* related to the pay-for-performance sensitivity of executive compensation. However, among the fact that their paper refers to a different time period (1992 – 1997) and to U.S. corporations, the pay-for-performance sensitivity is measured through the executive's option grant sensitivity following the methodology of Yermack (1995). We use the equity to cash and the variable to base compensation ratios as pay-for-performance measures, since option grants have become less popular over the past years.

Second, there is little theoretical support for the positive institutional influence on the total overall compensation. Hermalin (2005) provides a possible explanation for higher executive salaries. He shows that the board diligence increased over the past, which resulted in interdependent consequences. It is straightforward that the executive dismissal risk increases with the intensity of board monitoring and consequentially, shorter executive tenures are an apparent prediction. Also, Hermalin (2005) argues that the executive members must work harder due to the better monitoring by the board of directors. The higher effort in combination with the higher dismissal risk and the shorter tenure, must be compensated with a rising salary. It may be a reasonable hypothesis that powerful institutional shareholders require a higher board scrutiny and thus, affect the compensation in an indirect way. However, Peters & Wagner (2013) carve

out a difference to the mechanism proposed by Hermalin (2005). They similarly argue that the increasing compensation arises from the higher dismissal risk, but that changing industry conditions are the actual reason for the dismissal. Nevertheless, a higher executive dismissal risk may explain the rising total overall compensation with a higher institutional ownership concentration, but overall this finding is only weakly supported in the literature.

Third, although theoretical research shows that managerial incentive compensation *and* monitoring by institutional investors are beneficial (Shleifer & Vishny, 1986; Huddart, 1993) and could coexist (Holmström & Tirole, 1993; Burkart et al., 1998; Chidambaran & John, 1998), both are also costly. Incentive compensation, such as granting equity, is costly because of the risk aversion and the underdiversification of the managers (Ingersoll, 2006). Furthermore, Shleifer & Vishny (1997) show that incentive contracts create opportunities for self-dealing or even lead to manipulating accounting figures to increase the share price in the near-term. Furthermore, the outside monitoring by shareholders comes at higher cost, since it requires independent information and a potential free-rider problem with other shareholders may occur (Grossman & Hart, 1980). Large shareholders are a powerful way to reduce the free-rider problem and thus, reduce the cost of monitoring (Shleifer & Vishny, 1997). This reduces the necessity of expensive managerial incentive contracts and makes the monitoring an advantageous screening device. Consequently, a higher institutional ownership concentration and a lower equity compensation are consistent with theoretical arguments.

Finally, the literature that explains a lower variable compensation with a higher institutional shareholder concentration is similar to the equity compensation. Even large shareholders will never be able to perfectly observe the performance of the executives and managers always bear some residual risk with variable compensation parts (Shleifer & Vishny, 1997). Thus, according to Ingersoll (2006) a variable compensation comes at higher cost and could therefore be avoided by large institutional shareholders.