How strong are CEO performance incentives due to the threat of dismissal in Switzerland?

Bachelor Thesis in Banking and Finance

Swiss Banking Institute

University of Zurich

Advised by

Prof. Dr. Alexander Wagner

Submitted by

Stefan Strub

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Executive Summary

I Problem Background

In modern public corporations the owners (i.e. the shareholders) undertake the residual risk and delegate the daily business and control to a board of directors which in turn appoints a manager to head the company. This separation of ownership and control allows a superior way of risk diversification but as well originates the so-called principal-agent problem. This principal-agent problem is both caused by a conflict of interest and an information asymmetry between shareholders and managers. Shareholders have no deeper insight into the firms' daily business and therefore they can not accurately comprehend managers' decisions and value them in a long term view. In addition, shareholders generally have no incentives to monitor the CEOs closely. This gives managers the possibility to pursue their own agenda at the shareholders expense instead of maximizing shareholder value. Consequently, shareholders rely on mechanisms which give managers the incentives to act in their interest. One of these mechanisms is a credible turnover threat which should discipline managers and diminish the moral hazard problem. However, the threat of dismissal is only credible if poorly performing managers face a significantly higher likelihood of dismissal. In addition, it is important that an involuntary departure leads to severe, adverse consequences for a CEO. If these two conditions are fulfilled, the turnover threat will strongly discipline managers. Prior literature reports that ousted managers indeed suffered drastic implications, but the likelihood of a forced dismissal was very low until 1990. Therefore, the threat of dismissal was not credible and CEOs could pursue their own agenda. Recent studies about the US market indicate that the likelihood of a forced dismissal has increased lately what made the threat of dismissal more credible. Additionally, various other factors affect the implied dismissal risk. Amongst other things, empirical literature discusses the influence of exogenous shocks such as poor market or industry performance on forced CEO turnovers. Standard economic theory predicts that exogenous shocks do not influence the board of directors in their CEO retention decision. Empirical studies of Jenter and Kanaan (2006) and Heinzer (2008) contradict this hypothesis and state that boards do not fully filter out exogenous shocks and the likelihood of a forced CEO turnover increases with bad industry performance.

II Aim of the study

Motivated by these studies of observing the US market and using an actual hand collected data sample, this study examines the credibility of CEO performance incentives originated by the threat of dismissal in Switzerland. It analyzes the turnover-performance sensitivity and explores if the threat of dismissal has chronologically become more credible. Furthermore, it tries to ascertain whether exogenous shocks affect the likelihood of involuntary CEO turnovers.

III General Approach

At the beginning of the thesis, the basic theory of corporate governance and the principal-agent problem are introduced. After briefly discussing the main mechanisms to discipline managers and after giving an overview about prior empirical literature, the main part of the thesis will be reached. I attempt to answer my research question, if today in Switzerland the threat of dismissal in order to punish poor managerial performance is a credible one. For the purpose of answering this research question, I adopt a quantitative method. I examine CEO turnovers during the time period of 1993 to 2007 and include 1260 observations of 85 companies listed in the Swiss Performance Index into my analysis. Following largely the methodology of Jenter and Kanaan (2006), the turnover-performance sensitivity is analyzed by studying the relation between forced turnover and firm performance, expressed by stock returns. Since the board of directors does not fully filter out common shocks when deciding about a management turnover, it is important to include both the firm-specific and the market-based component of a lagged firm's stock return into the analysis to predict the likelihood of CEO dismissal. Following this procedure, the effect of poor managerial behavior (expressed by the idiosyncratic component of the stock performance) and the effect of poor market performance (expressed by the market-based component) at the risk of getting dismissed are quantified. The results of this analysis will explain whether the turnover threat is credible or not. Potential time patterns are surveyed by dividing the observations temporally into two sub-samples.

IV Results

Using a new hand-collected CEO turnover data set of total 1'260 observations, I find no significant relation between poor managerial behavior and an increased likelihood of forced turnovers. This finding is in contrast to prior studies and does not make the turnover threat in Switzerland credible. Moreover, poor market performance significantly influences the likelihood of involuntary CEO turnover.

Furthermore, I find that both low market performance in the previous year (t-1) and low managerial performance two years previous (t-2) significantly decrease the likelihood of CEO retention. Together with the significant influence of the market-specific component on the likelihood of forced turnover, this gives evidence that boards do not filter out exogenous shocks when deciding about CEO retention and thus commit systematic attribution errors by blaming CEOs for performance which is not directly attributable to managerial behavior. In addition, since managerial performance has in the previous year (t-1) no significant effect on CEO turnover at all, CEOs seem to depend only on market performance. In other words, managers who are fortunate enough to work in a good market environment face a significantly lower risk of a CEO turnover (forced or voluntary).

Even though prior literature reports that an ousted manager faces fairly severe adverse consistencies in case he gets dismissed, the performance-related turnover threat in Switzerland is not a credible one since there is a high possibility of unpunished managerial misbehavior. For the entire observed time period the likelihood of a dismissal is heavily fluctuating with an average of about 3.5%. Nevertheless, it is not statistically attributable to poor managerial behavior. This might change in the near future since I detect a recent increase in the difference between the turnover-likelihoods of best and worst performing managers, but at the moment performance incentives caused by the turnover threat are too weak to effectively discipline managers and to minimize the agency costs.