

How strong is the pay-performance sensitivity for Swiss Banks?

Bachelor Thesis in Corporate Finance

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11. August 2008

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Executive Summary

Introduction

When ownership and control of firms are separated, conflicts of interests arise. The resulting problem is a typical principal-agent relationship (Jensen and Meckling 1976), with shareholders being the principals and managers being the agents. This is especially the case for large public corporations with a large number of shareholders (principals). Owing to various reasons (a lack of qualification, for example) they delegate control to a number of agents (Fama and Jensen 1983). As a result, company management ends up with significant decision power. Being an utility maximizer itself comparing only the private gains and costs (Jensen and Murphy 1990a), management can take actions that harm the wealth of shareholders. To avoid this, the interests of shareholders and managers are to be aligned.

Such an alignment is often referred to as bonding. Shleifer and Vishny (1997) point out the importance of long-term incentive contracts to ensure the alignment of interests. In such contracts, managerial remuneration plays an essential role. To ensure bonding, managerial remuneration should be connected with observable performance and thus a measure of performance is needed. Jensen and Murphy (1990b) argue that a combination of basic policies will ensure the right monetary incentives for the management to maximize shareholder value.

Research question

The research question of this thesis asks whether an empirical relationship between pay and performance can be observed for the remunerations paid to management in Swiss companies with a special focus on banks. This relationship can be measured using a so-called *pay-performance sensitivity* (Jensen and Murphy 1990a), (Murphy 1985). This number indicates by what percentage management wealth rises compared to an increase in shareholder wealth. In addition to this main subject, the overall compensation situation in Switzerland is analyzed along with the determinants of the magnitude of remuneration.

Methods

To analyze compensation for Swiss companies, a database consisting of 47 firms listed in Switzerland has been built. The sample includes all 26 publicly listed Swiss banks and other financial and non-financial companies. On the one hand,

the inclusion of companies other than banks increases sample size and ensures the consistency of the statistical inference, on the other hand it enables the comparison of compensation determinants between financial and non-financial companies. Owing to the legal situation, compensation data are only available since the introduction of SWX's corporate governance directive in 2002 (SWX SwissExchange 2002). In addition, no individual compensation figures have to be disclosed. Due to this fact, only *total remuneration* amounts for the members of the executive board and the executive members of the board of directors are available. Starting from these numbers, *per capita remuneration* is calculated, dividing the total compensation amount by the number of executives. The data were mostly collected from the annual reports of the firms in the sample.

To present summary statistics and outline the compensation situation for Swiss banks, the companies were divided into banks, other financial and insurance companies and other companies. The banks group was further divided into subgroups according to the categorization proposed by the Swiss National Bank (Swiss National Bank 2007). The 26 banks consist of 11 cantonal banks, two big banks, three regional banks, six stock exchange banks and four other banks.

For the empirical part of the thesis, regressions have been carried out to examine the relationship between performance and the magnitude of compensation as well as between changes in performance and changes in compensation. Performance is measured as shareholder returns, as is common in the research on pay and performance. To enable regressions, the compensation data, organized in tables, had to be converted into data sets. Each regression has been carried out for both total and per capita compensation. In addition, two different regression methods were used. The first relationship between performance and absolute magnitude was tested using standard ordinary least squares (OLS) regression as well as fixed effects estimation using least squares dummy variables. As research emphasizes the importance of fixed factors (Murphy 1985) in such regressions, the second relationship, the estimation of pay-performance sensitivity was only carried out using fixed effect models.

To find potential differences, a dummy variable was introduced to discern banks from non-banks in the regressions. In addition to the relationship between pay and performance, the relationship between pay and firm size has also been tested. To this end, the companies' sales figures were used as an indicator of firm size.

Results

Both standard OLS and fixed effects regressions indicate no significant relationship between the magnitude of compensation and share performance for neither total nor per capita compensation. In contrast, the relationship between firm size and the magnitude of compensation is highly significant. A sales increase of 1000 Swiss francs leads to an increase of total compensation by one Swiss franc and an increase of per capita compensation by 0.1 Swiss francs.

The estimates of pay-performance sensitivity, calculated using fixed effects regressions yielded no significant relationship between changes in shareholder wealth and changes in managerial pay. In other words, a measure of pay-performance sensitivity cannot be calculated for Switzerland given the data available. However, the effect of an increase in firm size, measured by sales growth, is highly significant. A one percent sales growth leads to an increase in total managerial pay of 0.2% and of 0.3% in per capita remuneration. The dummy variables included in the models show no difference in pay-performance or pay-size sensitivity between banks and non-banks.

Conclusion

Share performance has no effect on management compensation. In contrast, firm size and sales growth play an important role. The 0.3% pay-size sensitivity is consistent with research (Murphy 1985), (Schwalbach and Grasshoff 1997). One may ask why such a relationship cannot be found in Switzerland, the more so as recent articles are able to empirically verify the existence of pay-performance sensitivity in other countries. Even though this fact could be interpreted in favor of the “managerialist” approach where firm size is the only important determinant, this need not be the case.

The question, whether an empirical relationship between pay and performance exists in Switzerland, cannot be finally answered using the data currently available. The fact that corporate governance directives were introduced much later in Switzerland than in other countries implies that no sufficiently long time series on management compensation figures exist. Furthermore, the disclosure principles lack consistency in the sense that the individual remunerations need not be disclosed and vary broadly among firms. An individual analysis of compensation, as proposed by Murphy (1985), is therefore not possible. This deficiency can harm the regressions and may explain the missing relationship, if only partly.

To give a final answer on the question of pay-performance sensitivity, some

years have to pass by for more and better data to become available. A highly increased sample size, that is, longer time series should smooth out the differences in disclosure. However, as long as no individual compensation figures are available, it will be very difficult to find an empirical relationship between pay and performance in Switzerland.