Do shareholders *care* about executive and board compensation? An event study approach

Bachelor thesis

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Executive summary

Research question

In this bachelor thesis, the question is studied whether shareholders *care* about board and executive compensation. The shareholders´ responses to specific pay events are deduced from an analysis of stock returns. In this thesis, pay events are defined as specific happenings that relate to compensation.

According to Cai and Walkling (2009), there are three possibilities, how shareholders can respond to pay events, which in turn suggest whether shareholders care. Firstly, the *alignment* hypothesis covers the view that remuneration systems are inefficient in their current form and restrain shareholders from maximising their wealth. Thus, owners of a company react positively to principles on compensation, which are expected to improve the efficiency of pay. Secondly, the *interference* hypothesis represents the position that remuneration systems are efficient. Regulation on compensation distracts the equilibrium and the maximisation of shareholder value. Based on this perspective, shareholders react negativly to pay events, but still care about compensation. The third possible response is the *neutral mutation* hypothesis, which describes the situation of no significant market reaction to a considerable pay event and therefore proposes that shareholders do *not* care about compensation.

Given the different forms of "caring", the analysis of stock returns is linked to an investigation on compensation data, which covers the 100 largest Swiss companies. The examination of remuneration will focus on the chief executive officer [CEO] and on the board of directors. According to the Swiss Code of Best Practice, the board is the ultimate direction of a firm and the linking pin between the company and the shareholders (Economiesuisse (2007)). The board and its specialised committees decide about the nomination and compensation of the executive committee and monitor the general risk and financial structure of a company. Given its functions and relation to the shareholders, the board plays an integral role for a firm and the adequate remuneration for the demanded qualifications of the board is of utmost importance for the company. The CEO concentrates on the operations and performance of a company. The latter is usually the highest paid member of a firm and consequently of special interest in the underlying study.

Empirical approach

The first step in this event study is the deliberate choice of pay events, which have to fulfil four important conditions. Firstly, the events or their subject matter have to be unanticipated ensuring that they are not priced in the market yet. Thus, adjustments of the share price follow (Schwert (1981)), which reveal shareholders´ reactions to compensation. Wagner and Wenk (2011), add that for information to be efficiently reflected in share prices a highly liquid market, which is open to domestic as well as foreign investors, is needed. The Swiss stock market fully satisfies this request and since this study focuses on pay events taking place in Switzerland this condition is met. Thirdly, pay events should cause notable change for a wide range of companies so that significant reactions can be observed in the stock market. Moreover, possibly confounding events around the event have to be controllable.

Based on these requirements, which are tested with the electronic format of the Neue Zuercher Zeitung and the LexisNexis database, the event of the official launch of the 1:12 initiative and of the press release to the draft on the FINMA Circular on remuneration systems is studied. The 1:12 initiative is a campaign, which was introduced by the Young Social Democrats, a Swiss social democratic youth organisation, and requests that the salary of the highest paid member of a company is not greater than twelve times the lowest salary. In contrast to the defined wage cap by this initiative, the FINMA Circular does not restrict wages but focuses on the adequacy of remuneration systems in the financial sector.

To determine the market reaction of these two pay events, the cumulative abnormal returns [CARs] are calculated, as the sum of irregular returns of a company. To obtain the CARs, stocks underlying the Swiss Performance Index [SPI] on the respective event day are analysed. The event day is supplemented by an event window that covers a period of ±1 days around the event day. In this way, market reactions before, due to news leakages, and after the event day, due to delayed news response, are considered.

To predict the normal returns of a company, an estimation window is employed which covers the price indexes of 250 trading days and which ends one day before the event window. Thereby, the standard market model is used to relate the risk-free adjusted returns of the individual stocks to the risk-free adjusted market returns. Given the regressions for each individual company, the normal returns for the event window can be calculated. Abnormal returns are then derived by subtracting the estimated normal return from the observed risk-free adjusted return for each day during the event window. The sum of the abnormal returns for every company gives the individual CARs. In the following investigations, the companies are split and grouped according to size and compensation characteristics so that the average CARs and the respective test statistics are calculated for the distinct set of companies.

To determine whether there is a relation between the market reactions, and the compensation levels, the CARs are compared to total and abnormal compensation of the board of directors and the CEOs. As in Wagner and Wenk (2011), normal compensation for CEOs is derived with a regression controlling for the size of a company, for the months spent in the company and for a potential double position as chairman. Additional to the variables to the CEOs, the directors´ normal pay is determined by the number of board members, a dummy variable for the function as chairman, and four further dummies for the membership in committees. In this way, normal pay is estimated for each member of a firm and the gap to the observed pay is called abnormal compensation. For the group of CEOs and the board of directors abnormal and total compensation is aggregated on a company basis.

Specific results and general conclusions

The first event under investigation is the official launch of the 1:12 initiative on 06.10.2009. Analysing the market reactions to this campaign, it can be observed that the overall average CAR for the event window is significantly positive. Given the assumption that this market reaction is due to the 1:12 initiative, shareholders value the requested wage cap and therefore follow the alignment hypothesis. Furthermore, when the companies are grouped according to size, the respective average CARs increase the larger the company.

In a next step, the relation between market reaction and compensation is analysed for the largest 98 companies underlying the SPI. The sample is split into quartiles according to total compensation. The average CARs, test-statistics and free float market capitalisations are related to the quartiles. It is shown that with greater levels of total compensation for the CEOs - as the usually highest paid member of a company - the (significant and positive) average CARs increase. With an increasing level of total compensation and market reaction, average market capitalisation also grows. Therefore, company size seems to go hand in hand with higher compensation. Consequently, the largest firms are the ones, which would be most affected by the wage cap defined by the 1:12 initiative and according to the CARs shareholders seem to value the initiative the most for these companies.

When the firms are split according to abnormal compensation of CEOs, it is found that the largest companies differentiate their market reaction based on excessive pay levels of CEOs. Thereby, companies with the greatest average market capitalisation show 1.7 times smaller CARs when CEOs are highly underpaid than when they are highly overpaid. The above described relations are not that clear for the board, which does not mean that the shareholders do not care about directors´ compensation but the event might just not relate to this group.

Based on the presented analysis for the CEOs, shareholders seem to care about the total level of compensation but also differentiate their market reactions according to excessive pay levels. To strengthen this conclusion, a second event is investigated.

In contrast to the 1:12 initiative, the press release to the draft on the FINMA Circular on remuneration systems does not set a wage cap but focuses on the long term sustainability of compensation and the efficiency of remuneration systems in the financial sector. To differentiate the financial and the non-financial sector a further dummy is added to the estimation of normal compensation. The analysis focuses on the financial sector and on the CEO and the Audit Committee [AC] (as part of the board), which is specifically addressed by the draft.

When the financial sector as a whole is investigated, no significant market reaction can be observed. However, a further split into insurances, banks and others (which include real estate companies and security traders) demonstrates a significantly positive average CAR of 2.46% for insurances and a significantly negative one of -0.78% for banks.

Opposing the market reactions to total and abnormal compensation, it can be observed that insurances pay not only much higher total compensation but also have higher *abnormal* compensation levels for the ACs as well as for the CEOs. Based on the described research method, the author concludes that shareholders of insurances value the Circular as a means to more efficient remuneration systems and thus follow the alignment hypothesis. Given the low abnormal compensation levels for banks, shareholders might feel that an overall efficient remuneration system already exists and will be harmed by the further directive of the FINMA.

Founded upon the presented evidence, this bachelor thesis concludes that shareholders generally care about the total amount of board and executive compensation. However, the specific market reactions in the form of the interference or alignment hypothesis depend on the pay event and the remuneration systems of the companies under consideration. Given total and abnormal compensation levels, shareholders seem to make astonishingly informed market decisions as is also shown by various empirical findings (e.g. Wagner and Wenk (2011), Cai and Walkling (2009)). Furthermore, it is found that depending on the specific pay event, shareholders care not only about the total amount of compensation but also about *excessive* pay levels to a certain extent.