An institutional approach to executive compensation: FTSE100 CEO pay 1980-2020

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‘An Institutional Theory of the Firm’
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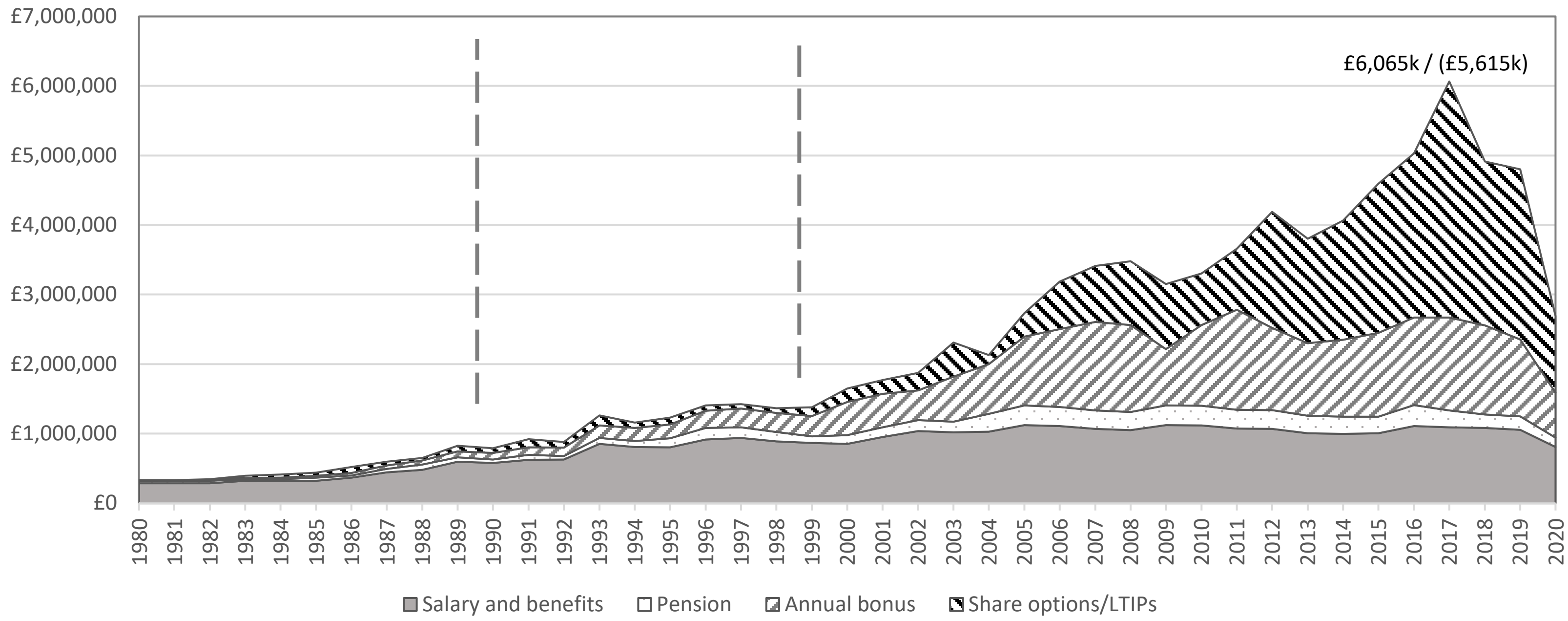
THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

The story of Richard V. Giordano

Airco Inc., COO, 1971, CEO 1978; BOC International plc, Chief Executive, 1979; Chairman & Chief Executive, 1985-1990.

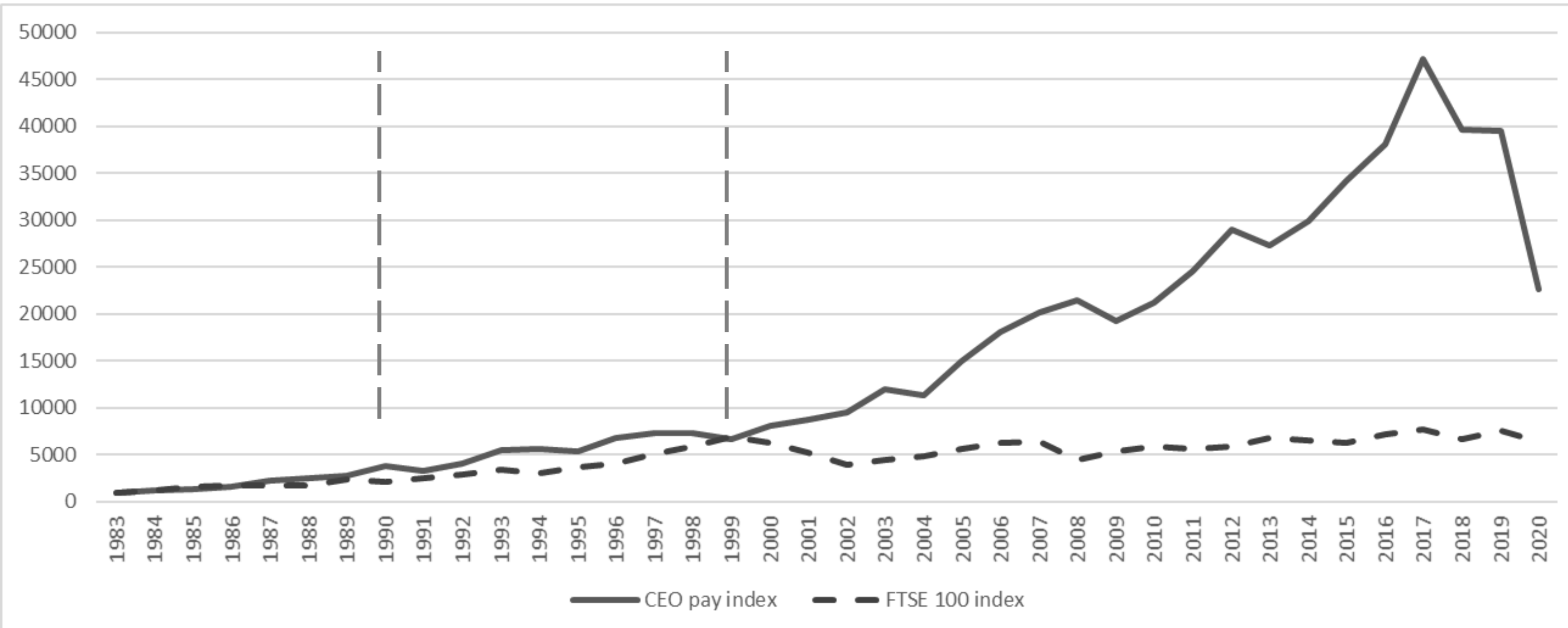
FIGURE 1. FTSE 100 CEO PAY 1999-2020 (INFLATION ADJUSTED)



STANDARD APPROACHES TO EXECUTIVE PAY

1. Optimal contracting (previously known as agency theory)
    - Jensen & Meckling, 1976.
    - The *'J twist'*— Jensen & Murphy, 1990.
    - The strongest correlation is with firm size — Gabaix & Landier,. 2008.
    - Some optimal contracting theorists argue that ex post focus on size is okay notwithstanding ex ante focus on financial performance, because biggest companies need the best talent.
    - BUT the *'But I'm still in Scotland'* fallacy.
2. The managerial power hypothesis (Bebchuk & Fried, 2004)
    - Friedman & Saks (2010) *'Neither agency theory nor the managerial power hypothesis is supported by the available evidence'*

FIGURE 2. FTSE 100 CEO PAY INDEX VS. FTSE 100 INDEX



MARKET FAILURES APPROACH TO EXECUTIVE PAY (1)

First order argument

…explaining the phenomenon

1. 'Labour is not a commodity like fish' — Robert Solow.
2. '*An efficient market requires many buyers and sellers, homogenous products (or at least good substitutes), free market entry and exit, plentiful information, and little economic friction (any factors that inhibit the free operation of the market). The problem with the market for top executives is that practically none of these conditions hold good'* — Pepper, 2006.
3. $\Rightarrow$ Inflation in CEO pay is the result of a **<u>market failure</u>**.

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MARKET FAILURES APPROACH TO EXECUTIVE PAY (2)

Second order arguments

…explaining the mechanism

1. Isomorphism, mimetic, coercive and normative — DiMaggio & Powell, 1983.
   - American pay practices, unforeseen consequences of pay regulation, compensation consultants and 'best practice'.
2. The remuneration committee's dilemma
   - It is rational for remuneration committees to defect.

FIGURE 3. THE REMUNERATION COMMITTEE’S DILEMMA

Company G, H, I and J

Company F	Pay average	Pay over the odds
Pay average	Second best for F, G, H, etc., = α	Best for G, H etc., worst for F = β
Pay over the odds	Best for F, worst for G, H, etc., = δ	Third best for F, G, H, etc., = γ

Assumptions: 20% of CEOs are superior and would create shareholder value in excess of average; 10% are inferior and would destroy shareholder value.

MARKET FAILURES APPROACH TO EXECUTIVE PAY (3)

Second order arguments (cont.)

1. Isomorphism – mimetic, coercive and normative (DiMaggio & Powell, 1983).

2. The remuneration committee's dilemma.

3. The investors' collective action problem

   - 'Most companies don't act on the remuneration feedback we give them' –– Angeli Benham, Senior Global ESG Manager, LGIM, 2021.

4. The LTIP valuation issue

   - Executives' subjective discount rate for risk = 17% and for time = 33%

   - Subjective value of LTIPs is < 30% of face value.

   - $\Rightarrow$ Companies increase amounts to compensate for perceived 'loss' of face value.

PROSPECTS FOR CHANGE

- Norwegian Sovereign Wealth fund - *'Remuneration of the CEO - Asset manager perspective'*, Norges Bank Investment Management, 17 April 2017. *'Get rid of LTIPs'*
- Weir Group – restricted stock plan, 2018. 50% haircut.

AND FINALLY…

The market failure approach to executive pay and the market failures approach to business ethics

Heath, J. (2014). 'A market failures approach to business ethics', in *Morality, Competition, and the Firm*. NY, USA: Oxford University Press.

Pepper, A. *If you're so ethical, why are you so highly paid.* To be published by LSE Press, Autumn 2022.