MGST 451

Corporate Governance and Ethical Decision-Making

Lecture 5 – Winter 2019 L01-L03

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Lecture 5 Agenda

1. Incentives for Management
    - What are incentives?
    - People respond to incentives!
    - Evolution of CEO compensation
    - Purpose of executive compensation
    - Components of executive compensation
    - Short-Term incentives
    - Long-Term incentives
2. Say-on-Pay
3. Protection of Shareholder Rights
    - Pyramid Structures
    - Cross-Holdings

Incentives

- "In incentive is something that motivates an individual to perform an action. … As such the design of incentive systems is a key management activity" (Wikipedia)
- Moral incentives
  - The right thing to do (self-esteem, approval of others)
- Natural incentives or intrinsic motivation
  - Out of curiosity, the pursuit of truth, etc.
- Remunerative or financial incentives
  - An agent expects a material reward for given action/result.
- Coercive incentives
  - When a person expects a negative consequence for having failed to act in a certain way or achieve a certain result.

Responses to incentives

- People respond to incentives, but not always as expected !
  - Different people with different preferences and circumstances might respond in very different ways…
- When designing an incentive system, one shall not underestimate the potential of unintended consequences.
  - Cannot fully predict the future + extreme events occur
- Perverse incentives: targets might be ‘achieved’ and rewards ‘earned’ by ‘gaming the system’ at great costs to the firm.
  - Manipulation of financial information;
  - Short-term gains at the expense of long-term success;
  - ‘double-up’ when behind (i.e. increase risk-taking to catch-up from lagging performance against targets).

Evolution of CEO compensation

It was common practice in the 1950s and 1960s to set management compensation in function of the size of the firm.

- Management responded by growing firms irrespective of profits.

Compensation was then set in function of profitability.

- Management responded by increasing profitability irrespective of risk or damage to future growth (lack of sustainability).

Management was then required to substantially invest in firm's equity.

- Management responded by lowering risk and future growth.

Management was then awarded stock options as extra compensation.

- Options were amended (back-dated) when stock price was too low to deliver compensation.

Clawback provisions were finally introduced to restrain Management

- Financial penalties when gaming the system too aggressively.

Purpose of executive compensation

- **Attract** the right individuals
  - Those having the skill set, experience and behavioral profile deemed required to succeed in the given position.
- Sufficient to **retain** those individuals
  - Competitive market between firms to hire successful executives.
- Right balance of incentives to **motivate them appropriately**
  - Encourage behaviors and actions consistent with corporate mission, vision, values, strategy, and risk profile.
  - Discourage behaviors and actions that are solely self-interested, especially if detrimental to shareholders and other stakeholders.

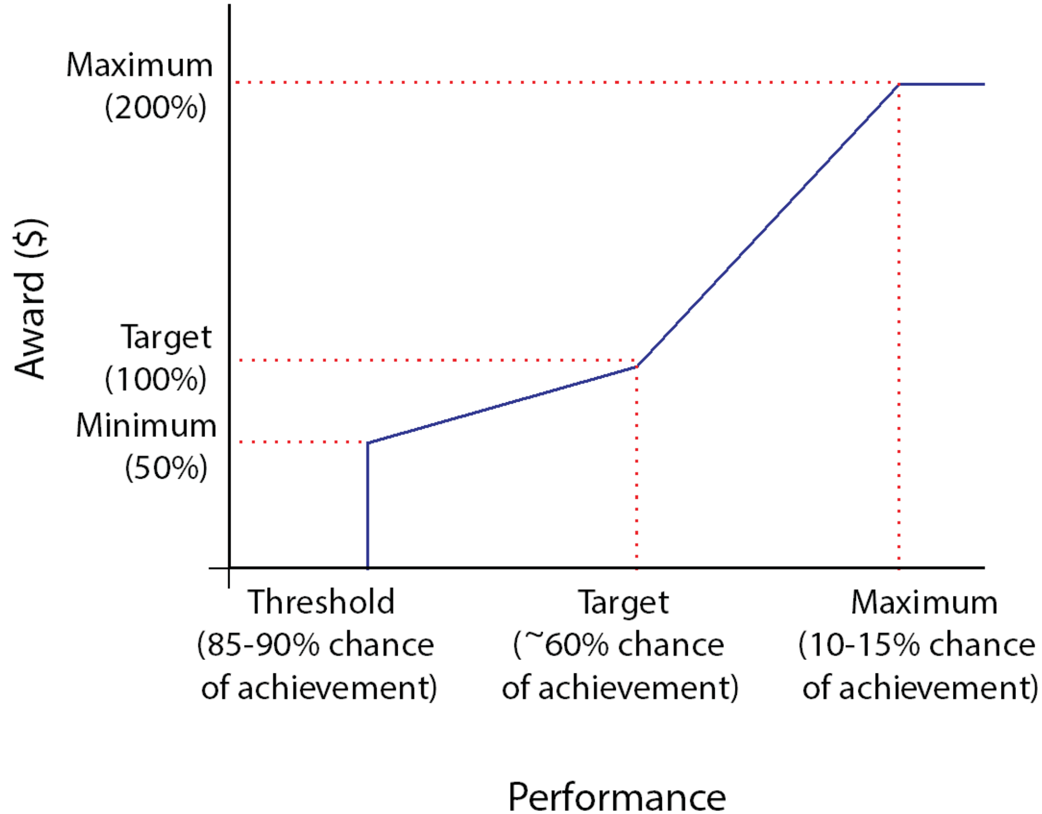
Components of executive compensation

- Base annual salary (fixed)
- Short-Term incentives (STI – typically financial year based)
  - Bonus paid in proportion to targets been achieved.
- Long-Term incentives (LTI – rolling 3 to 5 financial years)
  - Share price appreciation or other ‘shareholder value’
  - Need ‘vesting’ (i.e. cashable after some period of time)
- Employee benefits
  - Health-care plan, retirement plan, life insurance, …
- Paid expenses (perquisites)
  - Housing, car, chauffeur, executive jet, golf memberships …
- Contractual (i.e. golden parachutes for change in control, severance awards, post-retirement consulting agreements, …)

Short-Term Incentives (STI)

Proper alignment of target performance and payouts is crucial to incentive plan success

- Threshold performance levels are typically very achievable (85%-90% chance of achievement)
- Target performance levels are more difficult to achieve (~60% chance of achievement)
- Maximum performance levels are “stretch” goals, and very difficult to achieve (10-15% chance of achievement)



Source: Michael Benkowitz, Mark A. Borges, and Thomas G. Brown (2008).

Long-Term Incentives (LTI)

- Stock Options
  - Right (but not the obligation) to buy shares in the future at a pre-determined ‘exercise’ price up to the expiry date.
  - Past the vesting period (e.g. 3 years), the call option can be exercised (profit = current price – exercise price of share)
  - Encourage risk-averse managers to invest in higher-risk, higher-return investments.
- Restricted Stock Awards/Units (subject to vesting)
  - Grant of shares/units (but transfer/sale is restricted)
- Long-term performance awards
  - Grant of shares (or cash) conditional upon some long-term performance targets being met (next 3 to 5 years)

Say-on-Pay

- Shareholders are given the opportunity to vote on the executive compensation program enjoyed by Management (and sometime on the compensation of Directors too).
  - Retrospective (past) and/or forward looking (future)
- Since about 10 years it is increasingly common across OECD countries (now mandated by law or on a voluntary basis).
- The vote can be either binding or non-binding (i.e. advisory).
- These votes have approved the compensation packages ~98% of the times, typically with large majorities (~90%).
- However, and even when only advisory, if shareholders express their dissatisfaction, it often triggers adjustments to compensation, probably out of shame and loss of reputation.

Protection of Shareholder Rights

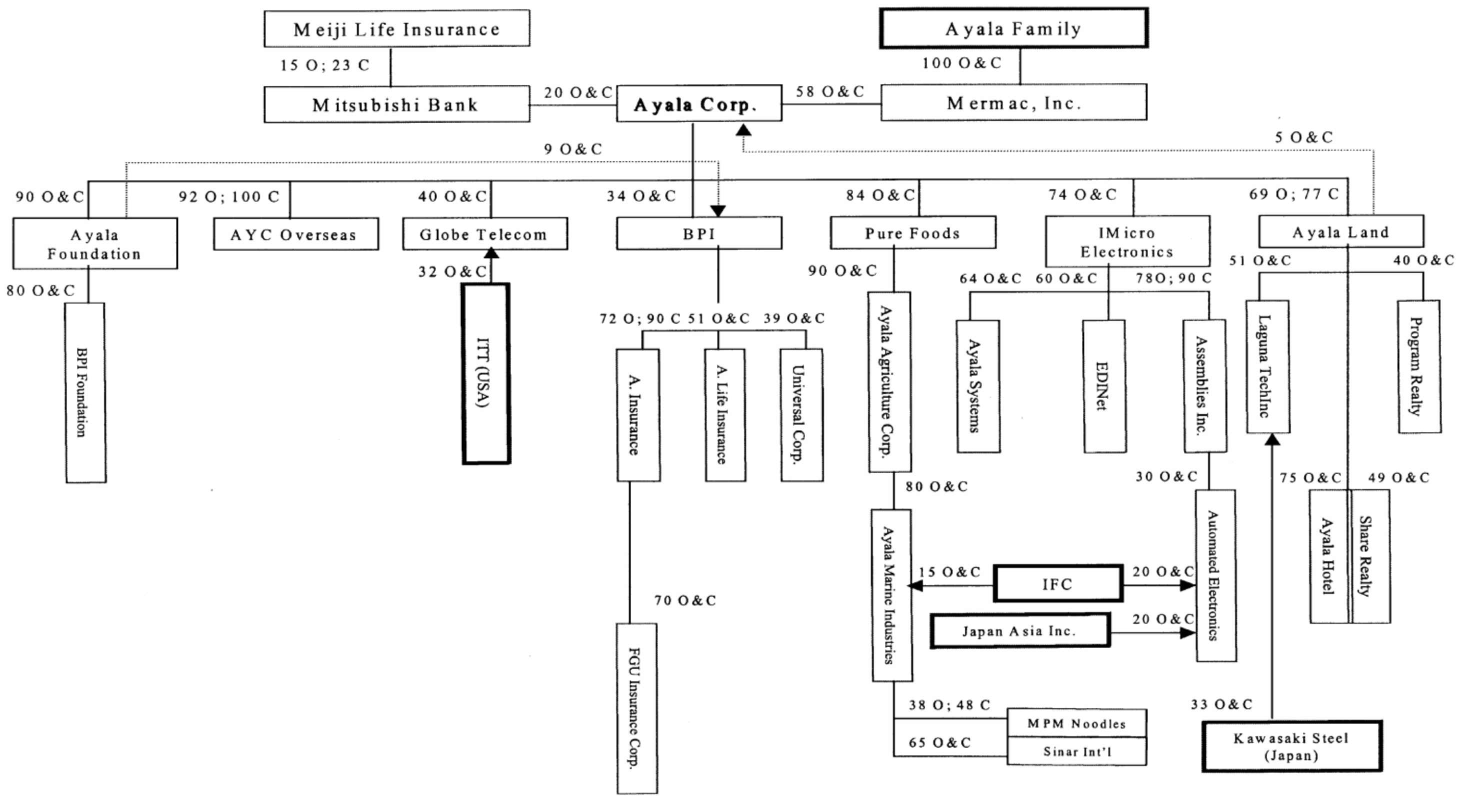
- In order to safeguard the interest of investors, various laws and regulations have been enacted to that effect in almost all countries. Otherwise the risk of loosing your investment by being taken advantage of would be too high and investors would refrain from investing, leading to no economic growth.
- However, these protections varies enormously by country.
- One area is the protection of ‘minority shareholders’ against ‘controlling shareholders’. When a firm is controlled by a single person (e.g. Facebook) or by a family (e.g. Prada), management is closely align with the controlling shareholder (and sometimes are the same people/individual).
- In addition to dual-class shares, pyramid structures and cross-holdings potentially create corporate governance problems.

Pyramid Structures

An individual or a group of individuals (e.g. a family) can achieve and maintain control through a chain of ownership relations.

- Called a pyramid structure as it kind of looks like a pyramid.
- Even without using dual-class shares and cross-sharehodings, lets say you control 51% of a firm, which in turn controls 51% of a second one, you achieve control of the second one with in reality only 26% ownership.
- Through various means, the controlling shareholder might be tempted to ‘tunnel’ cash flow from the second firm to the first one and then to itself, depriving minority shareholders.
- Anticipating such expropriation of cash-flow, minority shareholders pay less for such investment (confirmed by many empirical studies, see Berk footnote 25 on page 990).

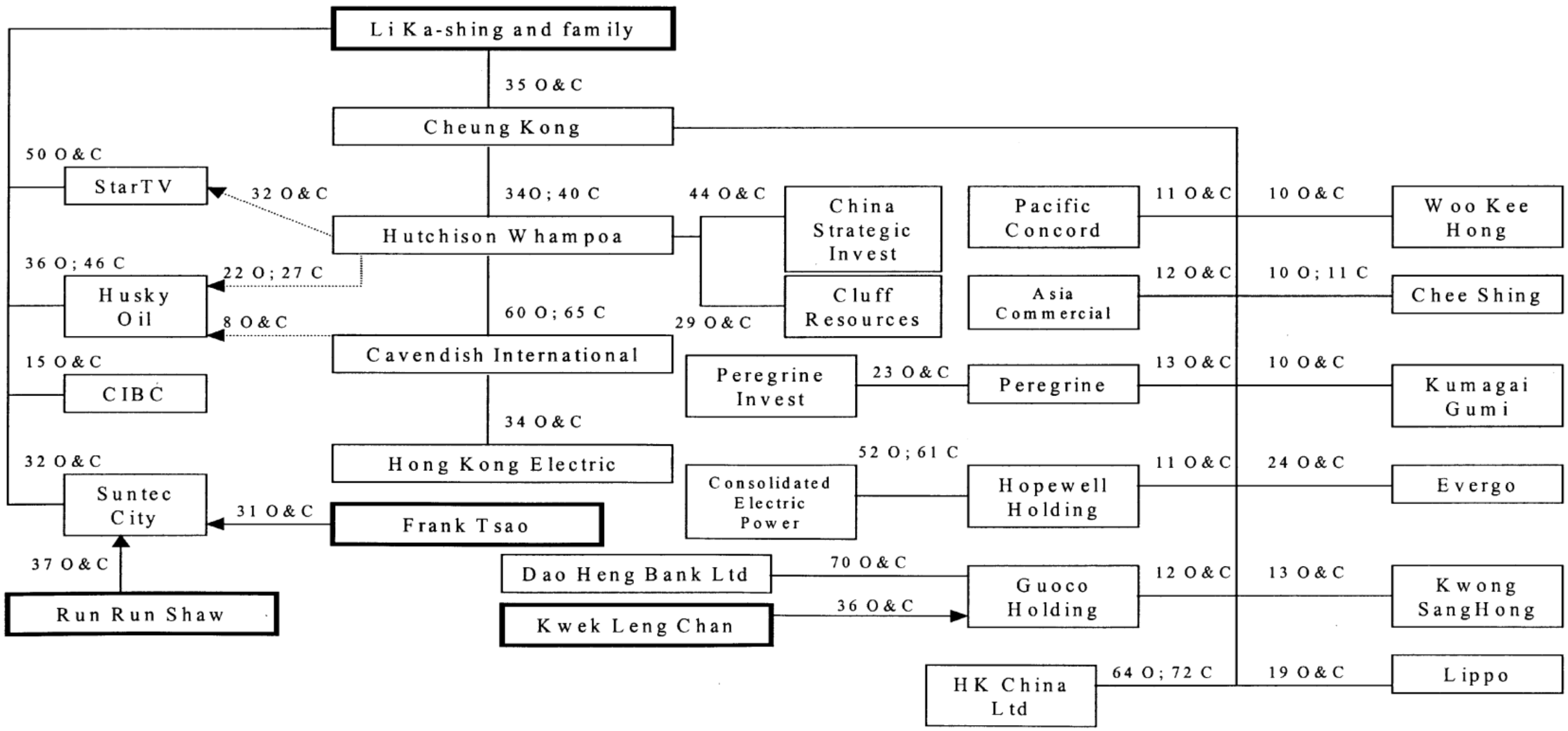
Ayala Group, Philippines (as of ~2000)



- Ayala Corporation: second largest market capitalization
- Ayala Land: largest market capitalization (0.58 x 0.69 = 0.4)
- Bank of the Philippine Islands: fifth largest market capitalization (0.58 x 0.34 = 0.2)

Source: Claessens et al. (2000)

Li Ka-shing Group, Hong Kong (as of ~2000)



- Cheung Kong: sixth largest market capitalization
- Hutchison Whampoa: second largest market capitalization (0.35 x 0.34 = 0.12)
- Dai Heng Bank is the largest: 22nd largest market capitalization

Source: Claessens et al. (2000)

Cross-Holdings

Cross-holdings arise when firm A owns shares of firm B while Firm B owns shares of firm A.

- Can potentially make corporate governance very complicated and ineffective, especially with numerous cross-holdings.
- Was common in Germany, but has been discontinued.
- Common in Japan where a group of firms, called ‘Keiretsu’, own each other shares and are financed by a given bank (operating in the same industry or linked by historic ties).
- Common in Korea, ‘Chaebol’ (but without a common bank).
- It could be very tempting for management to entrench itself using cross-holdings. If these also entails complex business relationships, it is then difficult for outsiders (and even insiders!) to understand what is going on.