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# Who should set Managerial Compensation?

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## ABSTRACT

There has been a long and popular tradition of assailing top management pay as "excessive" as well as claiming that it provides improper incentives. In the aftermath of the financial crisis it has been argued that flawed compensation arrangements have been an important cause of excessive risk taking and that these flaws stem from defects in the underlying governance structures that allow executives to wield considerable influence over boards. Undoubtedly, executive compensation and incentives will continue to be a hotly debated issue for years to come. The aim of this paper is to explain the key corporate governance mechanisms that influence executive compensation, such as the board of directors and the ownership structure and to provide a framework to understand the current debate on excessive managerial compensation and the value of giving shareholders decision power.

## KEYWORDS

Executive compensation, board of directors, ownership structure, risk taking behaviour.

## RESUMEN

Hay una larga tradición caracterizando la paga de la alta dirección como «excesiva» y asegurando también que lleva a incentivos

no adecuados. A raíz de la crisis financiera se ha argumentado que los acuerdos poco correctos de compensación han sido una causa importante de la toma de riesgos excesivos y que se derivan de defectos en las estructuras de gobernanza subyacentes que permiten a los ejecutivos ejercer una influencia considerable sobre los consejos. Sin lugar a dudas, la compensación ejecutiva y los incentivos seguirá siendo un tema muy debatido en los próximos años. El objetivo de este trabajo es explicar los principales mecanismos de gobierno corporativo que influyen en la remuneración de los ejecutivos, como el consejo de administración y la estructura de propiedad y proporcionar un marco para entender el debate actual sobre la compensación excesiva de los directivos de gestión y el valor de dar poder de decisión los accionistas.

**PALABRAS CLAVE**

Remuneración de directivos, consejo de dirección, estructura de propiedad, comportamiento de riesgo.

## 1. Introduction

In the aftermath of the financial crisis there has been no shortage of finger-pointing in the attempt to identify its underlying causes. The list of potential culprits is long and ranges from bank deregulation to poor corporate governance and excessive executive compensation. In this respect, PricewaterhouseCoopers and the Economist Intelligence Unit conducted a global survey of financial services industry executives and commentators in May 2008, asking which factors have created the conditions for the recent crisis. The results show that 70% of the participants indicated the reward systems and 73% the culture of excessive risk-taking to be responsible for the crisis.

Similarly, in a widely-cited book, Bebchuk and Fried (2004) argue that top-level executive compensation is not sufficiently linked to long-term corporate performance. There are several cases in which executive pay at companies rose dramatically even though the companies were doing poorly and the stock prices were plummeting. Stock options have been viewed as particularly culpable in this regard. Overly generous compensation packages with large-sized stock option grants may have created incentives for managers to manipulate company financial statements in order to drive up stock

prices, contributing to the corporate scandals, such as Enron, WorldCom, and Adelphia, the failures of venerable financial institutions such as Lehman Brothers and Merrill Lynch and the current financial crisis.

The argument that executive compensation[46] was not properly related to long-term performance led the Obama administration to discuss ways to change compensation practices, to closer align pay with long-term performance, and to give more voice to shareholders through the adoption of the "say on pay" strategy. One important issue when analyzing the risk taking behavior is the conflict of interest between managers and shareholders, identified by Jensen and Meckling (1976). Therefore, to understand the problem of excessive compensation, one needs to understand the conflict of interest that underlies the executive compensation as well as the role of the board of directors, who sets executive compensation.

Traditionally, the decision on the total amount and the structure of executive remuneration in public firms rests in the hands of the board of directors, who either decides the executive compensation directly or delegates the decision to its compensation committee. As a response to a controversial debate on seemingly "excessive" executive pay and the mismatch between pay and performance in some publicly-traded firms, the U.K. was the first country to introduce separate shareholder voting rights on executive pay, also termed as "Say on Pay." In the meantime, other countries such as France, Germany, the Netherlands, Norway, Spain, and Sweden have adopted similar rules. In 2010, the U.S. adopted the "Dodd-Frank Act". Section 951 of this act contains an amendment of the Securities and Exchange Act that obliges listed firms to conduct an advisory shareholder vote on the compensation of their top executives. In a separate resolution, the shareholders must determine whether the vote takes place every year, every two years or every three years.

This paper analyzes the claim that executive compensation has led to excessive risk taking and the effectiveness of say-on-pay measures. To this end, we first describe the conflict of interest between shareholders and managers. Second, we discuss the role of the board of directors and two

46. The executive with the highest compensation in 2011 in Spain is Inditex's CEO Pablo Isla, who received €2.4 million in fixed remuneration, and €1.725 million in variable remuneration (Bonuses and stock options). In addition, he received 221.264 shares, worth €13.6 million when he started as CEO on June 2011. In comparison, the CEO with the highest pay of the Fortune 500 firms in 2011 is John Hammergren, CEO of McKesson, with a total compensation of $131 million, of which $1.6 constitutes fixed salary, $4.6 million pertain to bonuses and more than $96 million stem from stock gains from restricted stock. McKesson made a $1.2 billion profit in 2011.

main governance mechanisms available to the board to solve this conflict, i.e. monitoring and executive compensation. Finally, we analyze how the effectiveness of monitoring and executive compensation depends on the ownership structure of the firm.

## 2. Conflict of Interests

Corporate governance relates to the "structure of rights and responsibilities among the parties with a stake in the firm" (Aoki 2001). Effective corporate governance implies mechanisms to ensure executives respect the rights and interests of company stakeholders, as well as guarantee that stakeholders act responsibly with regard to the generation, protection, and distribution of wealth invested in the firm (Aguilera et al. 2008). Even though managers' ownership in the firm may be small, the manager retains significant control rights (discretion) over how to allocate the investors' funds. In this setting, the manager makes choices that maximize his own objectives, which may deviate from those that maximize firm value. Mechanisms of corporate governance ameliorate these agency costs.

Both external governance mechanisms, such as the market for corporate control (e.g., Jensen and Ruback, 1983), the managerial labor market (e.g., Fama, 1980) and the external capital market (Prowse, 1997), and internal devices, such as the board of directors, are able to impact on the alignment of interest between shareholders and managers. The board bears the primary responsibility for avoiding agency problems by ensuring that the CEO puts shareholder interest above self-interest (Scherrer, 2003).

Agency theory suggests that boards have two main options to solve agency problems. First, boards may increase their monitoring effort to reduce the information asymmetry. Monitoring leads to less information asymmetry, which allows a better evaluation of the managers' performance and corrective action when appropriate. Better oversight therefore restricts managers in pursuing their own objectives over those of shareholders. Second, boards may alter CEOs' incentives to align CEO and shareholder interests. When a manager holds common stock and stock options, a dependence exists between his wealth and the firm's stock-price performance (see Jensen and Meckling, 1976). This dependence is commonly referred to as the wealth-performance relation. Since stock price varies over time, the payouts to this incentive scheme are uncertain, and risk is imposed on the manager. Smith and Stulz (1985) show that when managers' wealth is dependent upon firm performance, risk-aversion can cause managers to pass

up risk-increasing, positive net-present-value projects. They illustrate how shareholders can reduce this risk-related agency problem by using stock options or common stock to structure managers' wealth as a convex function of firm performance. Managerial decisions regarding project selection, risk choice, and level of perquisite consumption that maximize an optimally designed compensation package, therefore, minimize agency costs.

## 3. Board of Directors

Boards are by definition the internal governing mechanism that shapes firm governance, given their direct access to the two other axes in the corporate governance triangle: managers and shareholders. The board receives its authority from stockholders of corporations and its job is to hire, fire, compensate, and advise top management on behalf of those shareholders (Jensen, 1993) as well as monitor top management teams to assure they comply with the existing regulation. This delegation occurs because stockholders generally do not have a large enough incentive to devote resources to ensure that management is acting in the stockholders' interest. It is the duty of the board of directors to manage the company's affairs in the interests of the company and all its shareholders (fiduciary duty), within the framework of the laws, regulations and conventions under which the company operates[47]. Boards are therefore an alternative to direct monitoring by shareholders (Bebchuk and Weisbach, 2010). Board members depend on the CEO to provide them with relevant firm-specific information. Therefore, the better the information the CEO provides, the better is the board's advice but also the better the board can perform its monitoring role. In addition, boards typically delegate some of its duties to specific board committees such as audit, remuneration and nomination committees as additional monitoring controls.

Fama (1980) argues that the composition of the board of directors is important as it likely to influence the monitoring efforts of the board. Observers typically divide directors into two groups: inside directors and outside directors. Generally, a director who is a full-time employee of the firm in question is deemed to be an inside director, while a director whose primary employment is not with the firm is deemed to be an outside director. In

47. The interaction between the board of directors and Repsol's CEO Antonio Brufau, which has been well documented in the financial press, serve as a good example of the different types of conflicts of interests, i.e., between managers and shareholders, between large and small shareholders and between shareholders and debtholders.

recent years, public pressure and regulatory requirements have led firms to have majority-outsider boards and there is a lot more surveillance on what constitutes independence. The characteristics of boards of large U.S. corporations have been described in a number of studies. For example, Fich and Shivdasani (2006) find for a sample of 508 of the largest U.S. corporations that, on average, the board contains 12 board members, of which 55% are outsiders, and has 7.5 meetings a year. In comparison, Spanish Ibex-35 firms have an average board size of 14.4, of which 41% are independent and 37% are representatives of large shareholders, and meet about 11 times per year.

Boards are faced with an apparent paradox in that, on the one hand, they are expected to exercise control over the top management so that interests of shareholders (and other stakeholders) are protected; and on the other hand they need to work closely with the top management to provide valuable support in choosing corporate strategy and make informed decisions in implementing strategy (Hillman and Dalziel 2003, Sundaramurthy and Lewis 2003). The monitoring role of the board is rooted in the agency theory where the primary concern of the board is to curb the self-serving behaviors of agents (the top management team) that may work against the best interests of the owners (shareholders) (Jensen and Meckling 1976, Eisenhardt 1989). Agency theory strongly favors outside directors, those detached from management and daily operations, as they facilitate objectivity (Kosnik 1987), while separate CEO and chair positions provide further checks and balances (Rechner and Dalton 1991). Several theoretical papers in the finance literature examine why boards may not monitor too intensively. Warther (1998) shows how the management's power to eject board members may result in a passive board. Similarly, Hermalin and Weisbach (1998) use a manager's power over the board selection process to show how board composition is a function of the board's monitoring intensity. However, Almazan and Suarez (2003) argue that passive (or weak) boards may be optimal because, in their framework, severance pay and weak boards are substitutes for costly incentive compensation. Empirically, the evidence with respect to the relationship between board characteristics and firm performance has been mixed (e.g. Dalton et al. 1998, Dalton et al. 2007).

Most decisions about CEO pay are made by a compensation committee of a company's board of directors[48]. Research has shown that social forces in

48. Typically, the CEO hires a compensation consultant to determine what executives in the company "should" be paid and make a presentation to this committee, which almost always consists of company outsiders. Following the presentation, the committee asks the CEO to leave the room so it can come to a decision.

this room are an important driver CEO pay. For example, Crystal (1991) argues that corporate directors are ineffective in setting appropriate levels of compensation because they are under the control of and can be manipulated by the CEOs who hired them and who can remove them from their boards. Furthermore, Crystal claims that many directors are friends or business associates of the top managers and are, therefore, unlikely to oppose management pay raises or support pay cuts for poor performance. This argument, in particular, has had considerable play in the popular press[49].

Core at al. (1999) find for a sample of US listed firms that CEOs at firms with greater agency problems receive greater compensation and firms with greater agency problems perform worse. Specifically, they show that CEO compensation is higher when the CEO is also the board chair, the board is larger, there is a greater percentage of the board composed of outside directors, and the outside directors are appointed by the CEO or are considered "gray" directors. CEO compensation is also higher when outside directors are older and serve on more than three other boards.

## 4. Executive Compensation

Traditionally, corporate governance experts and economists have considered that management's interests are better aligned with those of shareholders when managers' compensation moves with shareholders' value. The design of executive compensation is, therefore, a key mechanism to deal with the conflict of interest between shareholders and executives in terms of differences in risk appetite (John et al., 1995). Table 1 summarizes and briefly explains the main components of the CEO compensation. In Spain, executive board member compensation is on average €1.1 million, which is significantly lower than the $8.6 million received by the CEO's of FTSE 100 companies or the $13.4 million received by CEOs of S&P 500 companies as reported in Renneboog and Zhao (2011) for 2007. Statistics of average compensation of directors and top executives for firms listed in the Spanish Electronic Market (Mercado Continuo) over the period 2004-2010 are shown in Table 2. The measure of compensation includes fixed pay, bonuses, and the execution of stock options.

49. For example, the Wall Street Journal (April 13,1994, p. R15) criticizes the executive compensation in an article entitled, "The Buddy System: The CEO wants a raise? No problem. We're all friends here".

| Component | Description |
|---|---|
| Base Salaries | Base salaries are a key component of executive employment contracts. Determined through competitive "benchmarking", based primarily on general industry salary surveys. |
| Annual Bonus Plans | The Annual Bonus Plan is based on a single-year's performance. Under the typical plan, no bonus is paid until a threshold performance is achieved, and a "minimum bonus" is paid at the threshold performance. There is typically a "cap" on bonuses paid. The range between the threshold and cap is labeled the "incentive zone", indicating the range of performance realizations where incremental improvement in performance corresponds to incremental improvement in bonuses. |
| Stock Options | Stock options are contracts which give the recipient the right to buy a share of stock at a pre-specified "exercise" (or "strike") price for a pre-specified term. Executive options typically become "vested" (i.e., exercisable) over time: for example, 25% might become exercisable in each of the four years following grant. Executive options are non-tradable, and are typically forfeited if the executive leaves the firm before vesting. The parameters of an option contract suggest a multitude of design possibilities |
| Restricted Stock | Restricted stock refers to stock of a company that is not fully transferable until certain conditions have been met (usually related to employee longevity). Upon satisfaction of those conditions, the stock becomes transferable. |
| Retirement plans | Top executives routinely participate in supplemental executive retirement plans (SERPs). SERPs can take a variety of different forms, including defined benefits based on years of service or variable benefits based on inflation or company performance. |

**Figure 1:** The Components of CEO Pay.

Two measures are commonly used to capture the incentives in executive compensation contracts: the pay-performance sensitivity, delta, which measures how much more an executive receives for a change in the firm's stock price; and the pay-risk sensitivity, vega, which measures the change in CEO compensation with respect to changes in stock price volatility. Higher deltas are thought to align shareholders and managers objectives, because managers share gains and losses with shareholders. As a result, higher delta should increase managerial effort to identify and commit to risky and positive NPV projects. However, high-delta contracts concentrate managerial wealth to the shares of the firm exposing managers to more risk. To the extent that managers are undiversified with respect to firm-specific wealth, they are more

risk-averse than diversified shareholders. Thus, higher deltas may increase managerial preferences to undertake low-risk investments (Smith and Stulz, 1985; Amihud and Lev, 1981). Option-based compensation can potentially reduce CEO preferences for low-risk decisions that arise from high deltas, by providing convex payoffs (i.e., high vegas).

| **Individual Average Pay** | **Mean** | **Median** | **Per 5** | **Per 25** | **Per 75** | **Per 95** |
|---|---|---|---|---|---|---|
| Directors | 294.700 | 179.200 | 46.500 | 98.600 | 336.400 | 822.600 |
| Executive Directors | 1.109.00 | 582.000 | 89.300 | 269.500 | 1.247.000 | 3.674.000 |
| Non-Executive Directors | 97.900 | 72.100 | 12.000 | 34.600 | 154.800 | 315.100 |
| Top Excutives non-Directors | 396.800 | 287.900 | 91.300 | 172.500 | 483.100 | 1.155.300 |

**Figure 2:** Descriptive statistics on compensation for firms listed in the Spanish Electronic Market (Mercado Continuo) over the period 2004-2010 (based on the Corporate Governance Annual Reports, available at the CNMV).

There exists a large body of literature recognizing that the convexity of the relation between stock price and manager's wealth (vega), in addition to the slope of this relation (delta), must be managed in the compensation contract to induce managers to make optimal investment and financing decisions (see Guay, 1999). The impact of high delta on is two-fold. On the one hand, high-delta contracts tie managerial wealth to shareholder value, in an attempt to reduce the conflict of interest between managers and shareholders (risk-increasing effect) (Jensen and Meckling, 1976; Morck et al., 1988; McConnell and Servaes, 1990; Berger et al., 1997). On the other hand, high-delta contracts concentrate managerial wealth on the shares of the firm, exposing managers to more risk. To the extent that managers are undiversified with respect to firm-specific wealth, they are more risk-averse than diversified shareholders, thus, increasing the risk faced by managers also reduces their utility. Accordingly, managers with a high delta contract may maximize their utility by foregoing some positive net-present-value projects that would increase firm risk (risk-aversion effect). High-vega contracts seek to mitigate managerial risk-aversion making risk more valuable to managers by increa-

sing their pay-risk sensitivity (Jensen and Meckling, 1976; Smith and Stulz, 1985). Then, option-based compensation, by providing convex payoffs, can potentially reduce the CEO preferences for low-risk decisions that arise from a high delta. Studies of industrial firms provide evidence that high-vega contracts encourage riskier choices while high-delta contracts encourage less risky policy choices (Knopf et al., 2002; Rogers, 2002; Nam et al., 2003; Coles et al., 2006; Guay, 1999).

Examples of egregious pay packages are clearly not hard to find. For example, Robert Nardelli received $210 million of exit pay from HomeDepot and Richard Grasso of NYSE received a pay package of $187.5 million while the NYSE was still a non-profit organization. Dennis Kozlowski, former CEO of Tyco, was granted nearly six million new options (5.1 million shares in Tyco plus 800,000 options in a subsidiary) valued at $81 million at the very time he was charged with looting the company of millions of dollars. But if these examples provide clear instances of excessive executive pay, they tell us little about the average level of executive compensation, and whether it is too high to attract, motivate, and retain the right people.

To understand the debate on excessive executive compensation, however, and the value of "say-on-pay" to solve excessive risk taking, it is crucial to compare the shareholder and managers risk preferences. On the one hand, to the extent that shareholders possess a diversified portfolio, they become risk neutral. On the other hand, the managers' wealth consists of a portfolio of tangible and financial assets as well as human capital (talent, job related experience). In contrast to other investors, managers' wealth is mostly concentrated in the firms they manage and managers are expected to protect their wealth by selecting "excessively safe assets" or by diversifying the firms' activities (e.g., Smith and Stulz 1985). Therefore, to maximize shareholder value, managers need to be incentivized to take more risk. This means that shareholder voting on executive compensation in unlikely to lead to less risk taking, if shareholders are more risk loving than managers.

## 5. The relationship between Monitoring and Executive Compensation

While there is a general consensus among scholars regarding the role of monitoring and incentives in controlling agency problems, there is less agreement about the nature of the relationship that exists between the two.

Monitoring and incentives have been characterized as substitutes[50] for each other (Zajac and Westphal, 1994) as well as complements to each other[51] (Tosi et al., 1997).

There are two main reasons underlying the confusion about the relationship between monitoring and incentives. First, the relationship between monitoring and incentives differs, depending on the context of the agency relationship. In particular, the extent to which the relationship between the agent's effort and relevant outcomes is known is central in understanding the ability of monitoring and incentives to control agency problems (Nilakant and Rao, 1994). If the effort –outcome relationship is not well understood, monitoring and incentives are likely to act as complements (Milgrom and Roberts, 1992).

## 6. Ownership Structure

The ownership structure is quite diverse across countries, with dispersed ownership being much more frequent in U.S. and U.K. listed firms, compared to Continental Europe, where concentrated ownership is prevalent (La Porta et al. 1999). Faccio and Lang (2002) report in a study of 5232 publicly traded corporations in 13 Western European countries that only 36.93 percent could be considered firms with dispersed ownership. In Spain, only about 1/3 of all listed firms are considered to have dispersed ownership.

The type of controlling owner is likely to influence the role of the board of directors as well as the executive compensation design. To understand the current debate on executive compensation it is therefore important to see the link with the board of directors and ownership structure. We

50. When one mechanism acts as a substitute for another mechanism, this refers to the direct functional replacement of the first mechanism by the second. An increase in the second mechanism directly replaces a portion of the first mechanism while the overall functionality of the system remains constant. If managerial incentives are aligned with shareholder interests such that acting in the best interest of shareholders is also in the best interests of the managers, then the need for the board to monitor the actions of management on behalf of shareholders is reduced and the governance mechanisms are substitutable. Similarly, if board monitoring is comprehensive and the board actively sanctions management when management is not acting in shareholder interests, then the alignment of managerial incentives to shareholder interests may be less necessary. Zajac and Westphal (1994) find that the use of long-term incentive plans for CEOs are negatively related to the monitoring processes in place; firms that have stronger incentive alignment tended to have weaker monitoring mechanisms and vice versa.

51. When one mechanism acts as a complement for another mechanism, this refers to the enhanced value of the first mechanism by the second, and vice versa.

briefly compare three prominent types of firms: family-controlled firms (e.g., Abengoa), corporate-controlled firms (e.g., Iberdrola Renovables) and firms with dispersed ownership (e.g., Telefonica).

Family control represents a distinctive class of investors in that they hold little diversified portfolios, are long-term investors, and often hold senior management positions, which places them in a unique position to influence and monitor the firm (Shleifer and Vishny, 1997). In addition, the distance from controlling shareholders to management is likely to be minimal, as very often owners will be managers themselves. Anderson and Reeb (2003) find that families that appear in both Forbes' Wealthiest Americans Survey and the S&P 500 have over 69 percent of their wealth invested in their firms and that family members serve as CEOs in about 43 percent of the family firms in the S&P 500. In addition, family members have excellent information about the firm, as a result of a long-term relationship with the firm, which means that they can monitor the operations of the company at a much lower cost than other monitors (Raheja 2005). Desender et al. (2011) argue that, as a consequence of substitution effects, boards in family firms are less focused on monitoring compared to boards in firms with dispersed ownership. In terms of the design of executive compensation, family owners are risk-averse because of their under-diversification. Undiversified wealth concentration enhances the motivation to monitor and exert influence in the invested firm to reduce its risk (Smith and Stulz, 1985; Shleifer and Vishny, 1997). Therefore, we expect that family ownership is associated with a lower preference toward risk. This preference is likely to be reflected in the executive compensation contracts as controlling family owners are likely to have ability to influence board decisions.

Corporate owners typically have a relatively undiversified investment portfolio, with a large fraction of its holdings concentrated in a single firm or in a small number of firms. In addition, corporate owners often invest in firms for strategic reasons, for example, to delegate part of its activities or to take advantage of potential synergies and spillover effects between the owner and the controlled firm (Tribó et al., 2007). The existence of reciprocal business relationships grants the controlling corporation with a better understanding of the business environment and with private information about the firm. Furthermore controlling corporations very often have access to board members, senior managers, suppliers, and customers. Such access allows them to exert greater influence on corporate decisions (Barca and Becht, 2001), such as the design of the executive compensation. Therefore, we would expect that direct monitoring by corporate owners may reduce the board's focus on monitoring. Furthermore, executive compensation is likely to be less risk-inclined due to the controlling firm's undiversified wealth.

Investors with a small stake in the company, aim to maximize the financial gains from a portfolio of investments, which make them more concerned about maximizing shareholder value and liquidity (Thomsen and Pedersen 2000, Aggarwal et al. 2010). Rather than spending time and resources to monitor or to improve the performance of a company in its portfolio, small investors tend to simply sell the shares of the under-performing company and walk away (Ingley and Van der Walt 2004). As a result, their influence within the firm is low. In this sense, CEOs may have more power and may be able to exert influence on the board and the compensation committee to provide an executive compensation that seeks less risk than what institutional investors would prefer. As these investors tend to have well diversified investment portfolio, they have a preference for high levels of risk. If the board of directors effectively represents its shareholders and seeks to maximize shareholder value, it should induce risk seeking incentive contracts. Table 3 provides an overview of how the characteristics of the shareholders are likely to influence the reliance on board monitoring and the degree of risk-inducing executive compensation schemes.

| **Control** | **Family** | **Corporate** | **Dispersed ownership** |
|---|---|---|---|
| Shareholder diversification | Undiversified; | Low | High |
| Risk preferences | Low risk | Medium risk | High |
| Ability to influence executive compensation | Direct | Direct | Through the Board of Directors |
| Monitoring ability | Direct | Direct | Through the Board of Directors |
| Executive Compensation policy | Low risk-sensitive | Low risk –sensitive | High risk-sensitive, if boards represent shareholders effectively. Low risk-sensitive otherwise |

**Figure 3:** Risk preferences, executive compensation and monitoring abilities for different types of firms.

## 7. Discussion

The debate over executive compensation is not one-sided. On the one hand, Bebchuk and Fried (2004) argue that flawed compensation arrangements have been widespread, persistent and systemic and that these deficiencies are due to defects in the underlying governance structures that allow executives to wield considerable influence over boards. On the other hand, Core, Guay and Thomas (2005) and Kaplan (2008) argue that many of these concerns about executive compensation are either incorrect or overstated. These authors point out that market forces heavily influence executive compensation that US executives have substantial pay-for-performance as a result of their holdings of stock and options, and that pay-for-performance for US executives is typically much larger than for executives in any other country. Finally, they point out that contracts with executives in many cases anticipate and try to minimize costs stemming from managerial power and other agency conflicts. Undoubtedly, executive compensation and incentives will continue to be a hotly debated issue for years to come and we do not contend to settle these disputes in this article. Rather, the aim of this paper is to highlight the key corporate governance mechanisms that influence executive compensation, such as the board of directors and the ownership structure and to provide a framework to understand the current debate on excessive managerial compensation and the value of giving shareholders decision power.

We argue that one size does not fit all, and that executive compensation is likely to be driven by the degree of diversification of the shareholders of the company. On the one hand, shareholders who hold undiversified investment portfolio, are more closely aligned with the managers, and are unlikely to induce risk-seeking incentives schemes. On the other hand, diversified shareholders need to incentivize their managers to take on risk. Therefore, our analysis suggests that regulators may consider ownership structure when setting regulatory constraint on executive incentives.

With respect to the debate of excessive compensation in the financial industry, we conjecture that the way to induce soundness and welfare is by keeping shareholders away of management. Banks' managers compensation should be set to align their incentives to those of debt-holders and society, not only with those of shareholders (which happens in standard agency theory). Then, optimal incentives should induce managers to maximize the economic value of banking assets while internalizing the social cost of failure. Furthermore, there is generally a misconception that the financial industry was paying its executives significantly more than in other sectors.

Core and Guay (2010) compares the total annual pay and the equity incentive structure of CEOs of banks and non-financial firms in 2006, the year before the credit crisis began. They show that bank CEOs received about 35% less annual pay in 2006 than CEOs of matched non-financial firms. Further, bank CEO performance and risk-taking incentives[52] are slightly smaller than that of the matched non-financial firm CEOs.

Furthermore, there has been a long and popular tradition of assailing top management pay as "excessive" as well as claiming that it provides improper incentives. As an example of this view, shortly after his election in 1992, President Bill Clinton signed Internal Revenue Code section 162(m) that limits tax deductibility of executive compensation to $1 million per covered executive, with an exception for performance-based compensation. This law promised to reign in "excessive" executive compensation (ironically, many have argued that this bill may have instead had the unintended consequence of increasing equity pay, equity incentives, and total compensation). In this sense, fix salaries may help to align managers' and shareholders' incentives with debt-holders and citizens' interests. Fix salaries may be complemented with extrinsic incentives in order to encourage efficiency while reducing an excessive risk-taking. This could be achieved through restricted stock or performance-bonuses bounded from above. The above example illustrates the complexity of setting executive compensation right from the shareholders perspective, as well as the dificulty to regulate executive compensation to achieve social welfare.

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52. CEO performance incentives are measured as the change in the value of the CEO's stock and option portfolio for a 10% change in the stock price. Risk-taking incentives are measured as the change in the dollar value of the CEO's option holdings for a 10% change in the volatility of the stock price.

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