



Blockholder monitoring and the efficiency of pay-performance benchmarking

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ABSTRACT

In this article I examine how the performance sensitivity of CEO compensation is related to the level and turnover of outside block ownership. Separating firm performance into firm-specific (*Skill*) and exogenous (*Luck*) components, I find that pay sensitivity to *Luck* increases with blockholder turnover, whereas pay sensitivity to *Skill* increases with blockholding size. Furthermore, when blockholder turnover is higher, CEO pay increases more with positive *Luck* but does not decrease as much with negative *Luck*; also, excess CEO compensation is larger. Thus, the rent accruing to CEOs via asymmetric pay sensitivity to *Luck* is partly explained by short investment horizons of large shareholders.

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1. Introduction

Recent research on executive compensation has focused on the incentive aligning efficiency of pay arrangements by more closely examining how CEO pay is benchmarked to firm performance. In a seminal study, [Bertrand and Mullainathan \(2001\)](#) document that CEOs get paid for exogenous shocks that affect firm performance (luck). Following this study, [Garvey and Milbourn \(2006\)](#) find that CEOs get paid for luck via asymmetric benchmarking of pay to performance; that is, pay increases when performance goes up because of exogenous shocks, but it does not decrease as much when performance goes down because of exogenous shocks. Although these regularities do not provide prima facie support for the efficient provision of incentives, recent theoretical and empirical studies argue that this asymmetry in benchmarking is optimal ([Celentani and Loveira, 2006](#); [Gopalan et al., 2010](#)). In this article, I examine the asymmetric benchmarking of CEO compensation by relating it to the monitoring role of large shareholders with heterogeneous investment horizons.

Large-block shareholders (henceforth blockholders) are prevalent in U.S. corporations ([Dlugosz et al., 2006](#); [Holderness, 2009](#)) and have been shown to play significant roles in corporate governance. Blockholders do this through a combination of intervening in firms' operations ([Shleifer and Vishny, 1997](#); [Bethel et al., 1998](#); [Kahn and Winton, 1998](#); [Gorton and Kahl, 2007](#)) and trading on private information ([Edmans, 2009](#)). I capture these aspects of blockholders' roles in firm governance by using two dimensions of block ownership: its level and turnover. If asymmetric pay-performance benchmarking is associated with inefficiencies in setting managers' compensation, more pronounced asymmetric benchmarking should be expected when block ownership is lower and blockholder turnover is higher.

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The traditional contracting view of pay-performance benchmarking suggests that rewarding CEOs for exogenous changes in firm value (i.e., changes that are beyond management control) is suboptimal because this would make contracts riskier and costlier but would not create incremental alignment of incentives (Holmstrom, 1979, 1982). Therefore, following Bertrand and Mullainathan (2001) and Garvey and Milbourn (2006), I split firm performance into two components: firm-specific performance (*Skill*) and firm performance driven by exogenous factors such as industry performance (*Luck*). I relate the level and the turnover rate of block ownership to the sensitivity of CEO pay to overall firm performance, each of the *Luck* and *Skill* components of performance, and the asymmetry in the relation between pay and *Luck*.

Following the literature, I measure outside block ownership as the sum of ownership stakes that individually constitute at least 5% of the voting rights and that are not affiliated with firm management. The extant literature examining ownership turnover focuses on institutional ownership and captures the effect of turnover by classifying institutional owners based on the frequency with which they turn over stocks in their portfolio (Bushee, 1998, 2004; Gaspar et al., 2005; Chen et al., 2007). By examining the turnover of block ownership at the investee firm level, I extend the literature on investor horizons to this important group of investors. I calculate block ownership turnover as the proportion of total block ownership that changes hands annually, thus developing a firm-specific measure that allows for heterogeneity in a particular blockholder's behavior across firms.¹ A greater rate of block ownership turnover indicates a shorter average investment horizon. All else equal, blockholders with longer investment horizons are assumed to be more active in monitoring, and thus turnover rates of block ownership are used as an inverse proxy for blockholder monitoring.²

I start my examination by relating the pay-performance sensitivity (PPS) of CEO compensation to outside block ownership and find that the sensitivity of CEO compensation to firm performance is positively associated with both the level and the turnover rate of outside block ownership. However, the sources of the increased PPS due to each of these dimensions of block ownership are different. When I split total firm performance into *Skill* and *Luck*, I find that higher blockholder turnover (i.e., shorter average investment horizon) is associated with increased pay sensitivity to *Luck*, whereas higher level of block ownership is associated with increased pay sensitivity to *Skill*. These results suggest that CEO compensation is more sensitive to *Skill* than *Luck* when firms have better monitoring by blockholders as measured by their larger stakes and longer investment horizons.

I next test whether large shareholders reduce asymmetric pay-performance benchmarking by examining the effect of block ownership and blockholder turnover on PPS when firm performance is conditioned on the sign of *Luck*. I find that the level of block ownership is not differentially associated with PPS based on whether *Luck* is positive or negative. However, greater blockholder turnover makes CEO pay more sensitive to *Luck* only when *Luck* is positive. When *Luck* is negative, greater blockholder turnover leads to smaller PPS to *Luck*, preventing CEOs from being penalized for poor *Luck*.³ This result suggests that shorter investment horizons of blockholders can exacerbate the asymmetry in pay-performance benchmarking.

I further examine the effect of blockholder turnover on the asymmetric sensitivity of pay to *Luck*. First, I test whether the exacerbating effect of blockholder turnover on this asymmetric sensitivity is mitigated by the existence of a director blockholder. I expect that a director blockholder compensates for limitations in monitoring arising from short horizons of other blockholders. Consistent with this expectation, I find that the presence of a director blockholder considerably decreases pay sensitivity to *Luck* in general and increases the sensitivity of pay to *Luck* when *Luck* is negative, thus making CEO pay sensitivity to *Luck* more symmetric.

Second, I test whether pay sensitivity to *Luck* and *Skill* varies across the following blockholder types: (1) banks, insurance companies, investment companies, and investment advisors; (2) pension funds; (3) corporations; and (4) activists and individual investors. Although in the current sample these four groups of blockholders are generally similar in terms of their blockholding size, their turnover rates differ from one another. The average turnover rate is 24.89% for banks, insurance companies, investment companies, and investment advisors; 13.43% for pension funds; 6.14% for corporations; and 4.99% for activists, and individuals. Consistent with this variation in turnover rates, pay sensitivity to *Skill* generally increases in the level of block ownership when the block is owned by pension funds or by activists and individual investors. In contrast, pay sensitivity to *Skill* decreases in the level of corporate block ownership, suggesting that the motivations of corporate blockholders differ from those of activist or individual blockholders. When the block is owned by banks, insurance companies, investment companies, or investment advisors, an increase in pay sensitivity is observed only for cash compensation. More importantly, the relation between blockholder turnover and asymmetric pay sensitivity to *Luck* continues to hold even after accounting for the effect of block ownership type, suggesting that blockholder turnover and blockholder type, despite their similarities, are not perfect surrogates for each other.

Finally, I test whether greater asymmetry in pay-performance benchmarking due to higher blockholder turnover results in greater excess CEO compensation. I expect it will because CEOs of high-blockholder-turnover firms are more likely to receive higher pay when *Luck* is positive and smaller penalties when *Luck* is negative, thus resulting in higher pay on average. I find that total CEO compensation and equity-based compensation are larger in firms with higher blockholder turnover, whereas cash-based compensation is not.

¹ Details of the measurement are in Section 3, and Appendices B and C.

² I recognize that low turnover rates of block ownership could also be driven by blockholders with passive investment strategies, such as index funds. To the extent that low turnover reflects such passivity, blockholder turnover will not be systematically associated with benchmarking of CEO compensation and hence will bias against finding significant effects.

³ This asymmetry is primarily from the equity-based component of total CEO compensation. A potential explanation for this result is that during the sample period, stock options in CEO compensation did not affect the firm's net income whereas cash compensation did (based on APB No. 25, firms were not required to expense stock option grants if the granted options were at the money on the grant date). Therefore, firms would have found it easier to use stock options than cash to pay CEOs for *Luck* without raising a red flag to shareholders and the public.

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