Article title: How to attract the best possible executive to be your new CEO

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How to attract the best possible executive to be your new CEO

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How to attract the best possible executive to be your new CEO

Abstract. The two information asymmetry problems I face in hiring my next CEO are adverse selection and moral hazard. Information asymmetry problems arise when two parties have different levels of information. For example, if an employer hires an employee, each party has information which the other does not have. The employer knows the difficulty of how the work is to manage but the employee knows what amount of work he is willing to contribute. This is called the principal-agent problem. The principal is the employer who hires an agent, the employee to work for him. A principal-agent problem only comes up when information asymmetry exists.[1] Two major problems of asymmetric information are adverse selection and moral hazard. Adverse selection is the issue of pitching the right type of agent. Moral hazard is the issue that the agent shirks after being hired.[2] For example, if the British Secret Intelligence Service hires James Bond, it has to consider the adverse selection problem before the hire and the moral hazard problem after the hire.[3] The problems the government would have to select the ideal candidate who is willing to kill on behalf of the country and for a government paycheck are the adverse selection problem. An adverse selection would be a person who is willing to kill for any other reason like a psychopath. The moral hazard problem is to make sure that the candidate does not change behaviour and is willing to work as hard as before the hire. James Bond for example has the incentive to exaggerate the difficulty of the assignment to extend his exotic life on the assignment. The government instead has no information if Bonds exotic requests are justified because Bond is the expert.[4]

1. The different elements of a good compensation package would be…

…base salary, bonus, and restricted share plans. In a good compensation package for a public listed firm fixed and variable pay as well as long- and short-term incentives would be balanced. Compensation based on performance should be aligned with business strategy and

[1] Rau, 2016, p. 6
[2] Rau, 2020, 1/4
[3] Rau, 2020, 2/4
[4] Rau, 2016, p. 6-7

goals. The compensation should be aligned with general conditions in company e.g., business size, complexity, and geographical location.[5]

Core compensation elements
Base salary
Bonus
Stock options
Restricted share plans
Pension and benefits

Fig. 1: Core elements of CEO's compensation

Base salary

The first element of a good compensation package is the base salary (see Figure 2). The base salary is determined by pay benchmarks based on an industry salary survey. The company size is a critical component. It is a fixed payment; therefore, risk-averse executives would prefer it.[6]

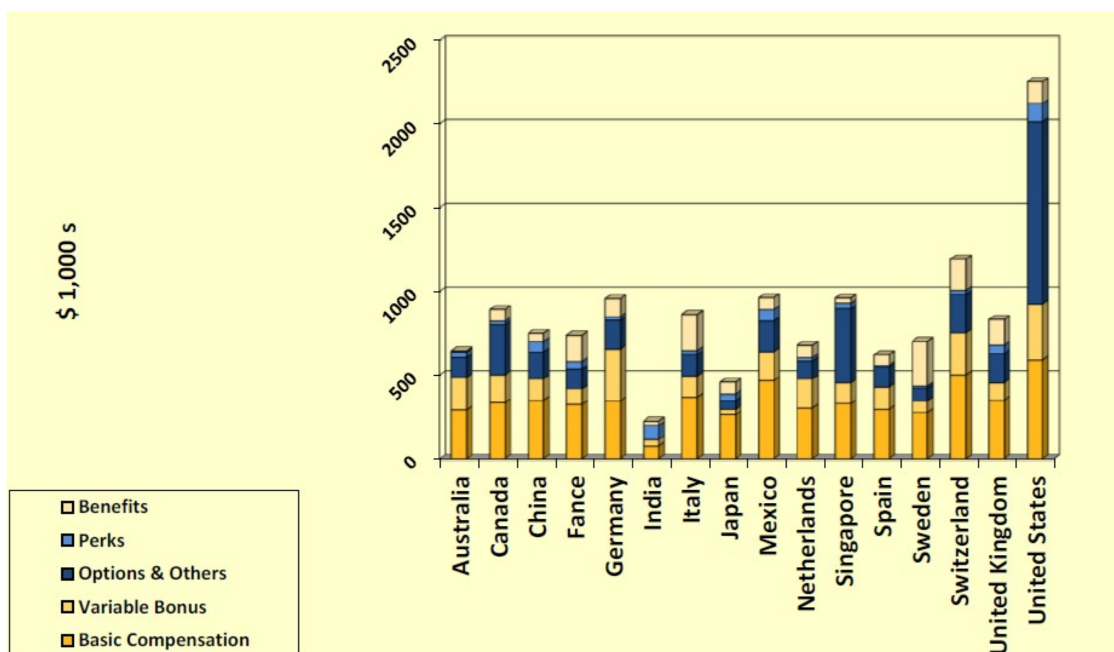

Fig. 2: Structure of CEO compensation across countries[7]

[5] ABI, 2002
[6] Kostyuk, Stiglbauer and Govorun, 2016, p. 26
[7] Rau, 2020, 3/4

Bonus

A bonus would be the second component of a good compensation package for CEOs. The annual bonus plan based on performance over a year.[8] It is defined by three basic elements: performance measure, performance standards and the structure of the pay-performance relation.[9] A target bonus of in general 120% is paid for the achievement of the performance standard.

Stock options

The third element of the package is equity because it perfectly aligns the theory of incentive alignment and signalling.[10] Equity can mean stock options or (restricted) shares.

A stock option contract gives CEO right to buy a share of stocks. In principle, stock options entail the measure of the performance of senior executives, but they do not set the right level.[11] (See Question 3.) Consequently, it is not preferably a component of a good remuneration package. In conclusion, one can say that stock options are so high because they solve moral hazard problem, but they do not solve the adverse selection problem.[12]

Restricted share plans

On the contrary, a restricted stock entails a period of restriction. This means that they still provide value at a later point in time; they does not give up the bargaining power of the board by implementing particular conditions that must be fulfilled before they can be sold. The stock options instead do not prevent the CEO from walking away.[13]

The restricted stock should include a vesting option usually in four to five years' time. The time horizon should not be less than two years to ensure a long-term incentive to fulfil the

[8] Kostyuk, Stiglbauer and Govorun, 2016, p. 26
[9] Murphy, 1999
[10] Rau, 2020, 4/4
[11] Kostyuk, Stiglbauer and Govorun, 2016, p. 27
[12] Rau, 2020, 4/4
[13] Rau, 2020, 3/4

condition. If the CEO has the choice between stock options or restricted stocks, the choice even signals which CEO is likely to stay in the company.[14]

The vesting schedule should be a staggered vesting of increasing amounts over this period of time with a quarterly amount of 1/16 of the option for four years. This incentivises the CEO to work hard every quarter. By relying on the industry practice to give some portion right away, the committed implements a commitment mechanism to signal that both sides trust each other.[15]

In conclusion, the CEO should be restricted in her options to play the numbers. Therefore, the design of the incentive plans as well as its monitoring are a crucial part of corporate governance.[16]

The different tradeoffs to the stakeholders in the firm are…

…all sorts of agency costs that arise between stockholders and managers, creditors and stockholders and different type of shareholders.[17]

Generally, stakeholders of the financial services firm are employees, board members, community, creditors, shareholders, customers, suppliers, governments; and managers.[18] A bank's scope of corporate governance goes beyond equity governance, that is, shareholders, and includes debt governance, that is, debt holders.[19] These stakeholders include all persons who have a stake in the success of the firm.[20] But the firm should be managed in the interests of the shareholders.[21]

To take into account the stakeholders in the firm, multiple goals must be maximised. This creates agency costs. In the principal-agent relationship are the shareholders the principals

[14] Rau, 2020, 4/4
[15] Rau, 2020, 3/4
[16] Rau, 2020, 3/4
[17] Rau, 2020, 3/4
[18] Kostyuk, Stiglbauer and Govorun, 2016, p. 49
[19] Hopt 2012, 2013
[20] Rau, 2016, p. 14
[21] Rau, 2016, p. 17-18

and the CEOs the agents. But the question is if CEOs will work in the shareholders' best interests. This is where all sorts of all sorts of agency costs arise. In conclusion, these are problems of coordination.[22]

The biggest challenge is how a financial institution should design the remuneration of its employees, managers, and the board. As the remuneration report of Deloitte (2013)[23] illustrates, employees, chief officers, and directors receive annual and long-term variable payments.[24] Directors' remuneration packages vary from industry to industry and perhaps from company to company and firm size. Industries like financial and manufacturing, rely on accounting performance as a major benchmark in compensating CEOs. According to previous research, the firm size has influenced CEO compensation. The ownership structure also has an influence on the design of directors' remuneration (see Figure 3).[25]

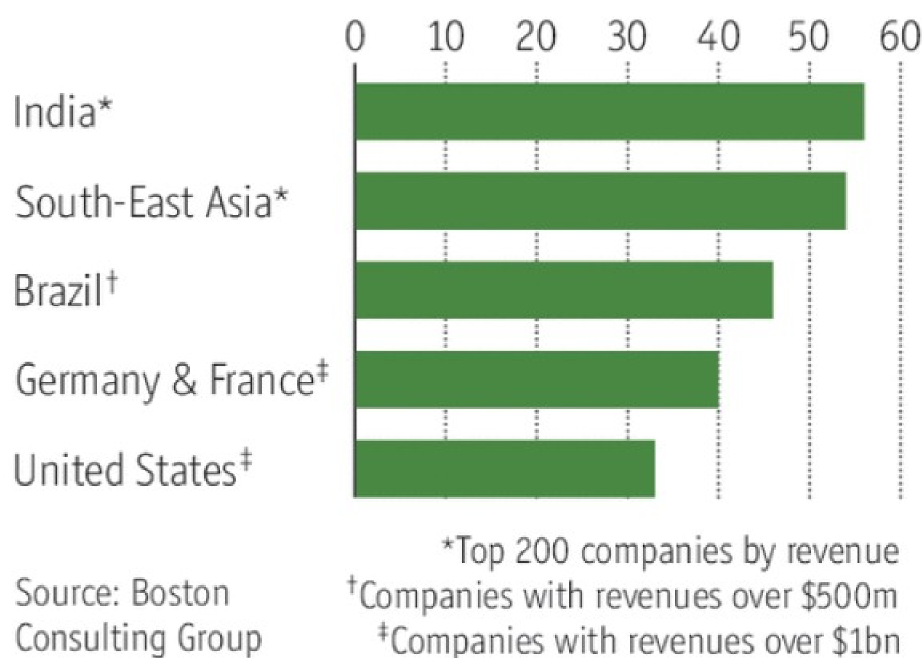

Fig. 3: Concentration of ownership around world, Family business as % of top companies latest available[26]

[22] Rau, 2020, 3/4
[23] Deloitte, 2013
[24] Kostyuk, Stiglbauer and Govorun, 2016, p. 52
[25] Kostyuk, Stiglbauer and Govorun, 2016, p. 66
[26] Rau, 2020, 4/4

My proposed compensation package solves the moral hazard problem in part 1…

…but does not solve the adverse selection problem. There are two solutions to solve the adverse selection and moral hazard problem: signalling and screening. Both show shareholders that their money is safe.

Firstly, the proposed compensation package functions as an incentive contract which ex ante aligns the interests of the CEO with those of the shareholders by a long-term contract. This solves moral hazard problem. Consequently, the compensation package is structured in that way that it pays off only in the case that the CEO maximises the shareholder value and not in the case if she destroys the shareholder value. The package contains these components such as share ownership and dismissal in the case of a low share price. This means that the CEO has an incentive to work hard for the shareholders. If he does not, the share price will not rise and consequently the shares will not have any value. The pay of the CEO is therefore depended on his choice to work in the shareholders' interests.[27]

Secondly, in contrast, the proposed compensation package does not solve the adverse selection problem. Huge equity payments would attract overconfident CEOs who think that they can rise the share prices significantly but at the expense of the long-term performance of the company. Consequently, there is evidence that the higher the amount of stock option payments, the lower is the long-term performance of the company.[28]

Furthermore, the signalling might give a solution to solve the adverse selection problem. Signalling is when the agent – the party with more information – chooses an action to reveal her type. Whereas screening is when the principal – with less information – gives the agent a menu of payoffs to make agent reveal her type.[29]

[27] Rau, 2016, p. 21-22
[28] Rau, 2016, p. 21-22
[29] Rau, 2020, 2/4

One application within firms is the labour market. Economists assume two types of workers: good and bad. The employer does not know which one is good or bad because every worker lies to be a good worker. The poor worker profit from this asymmetric information because their salary is much higher than if they would be recognised as a poor worker. This would hurt the good workers. Consequently, they need a signal to show the employer that they work hard which has to be costly otherwise it could be copied by the bad workers. One signal is education, e.g., an MBA business degree.[30]

In the case of Ms. Kinnett, she might have revealed her type and intentions through her demand for stock options instead of a good compensation package with existing restricted share plan like the example of Netflix.[31] This would make her an inappropriate candidate.

2. **By evaluating the package Ms. Kinnitt would like to receive…**

…it becomes obvious that it does not limit her be excessively and underserved compensated and does not match the underlying long-term investor time horizons.

Good compensation package	Ms Kinnitt's desired package
Base salary	Higher basic salary
Bonus	Guaranteed bonus
Stock options	Share options
Restricted share plans	
Pension and benefits	Golden parachute

Fig. 4: Good vs. Ms Kinnitt's desired compensation package

Base salary

Firstly, the lawyer of Ms. Kinnett demands a "higher basic salary". He justifies this with the objective she likes to achieve: an increase in size and market share.

The compensation consultant bases his argument to justify the higher base salary on a "peer group of similar sized firms in the S&P 500 that have grown in market share by over 20% in the past year".

[30] Rau, 2020, 2/4; Rau, 2016, p. 8-10
[31] Rau, 2020, 4/4

The base salary is a fixed payment. In general, it should be determined by pay benchmarks based on an industry salary survey. The company size is a critical component.[32] Ms. Kinnitt's lawyer justifies her request of a higher base salary with the future objective she would like to achieve. The peer group of similar sized companies which have already grown their market share might be inappropriate. (See Question 5.) The demand of a higher base salary might be exaggerated. It might not limit her to be excessively and underserved compensated (see Figure 5).[33]

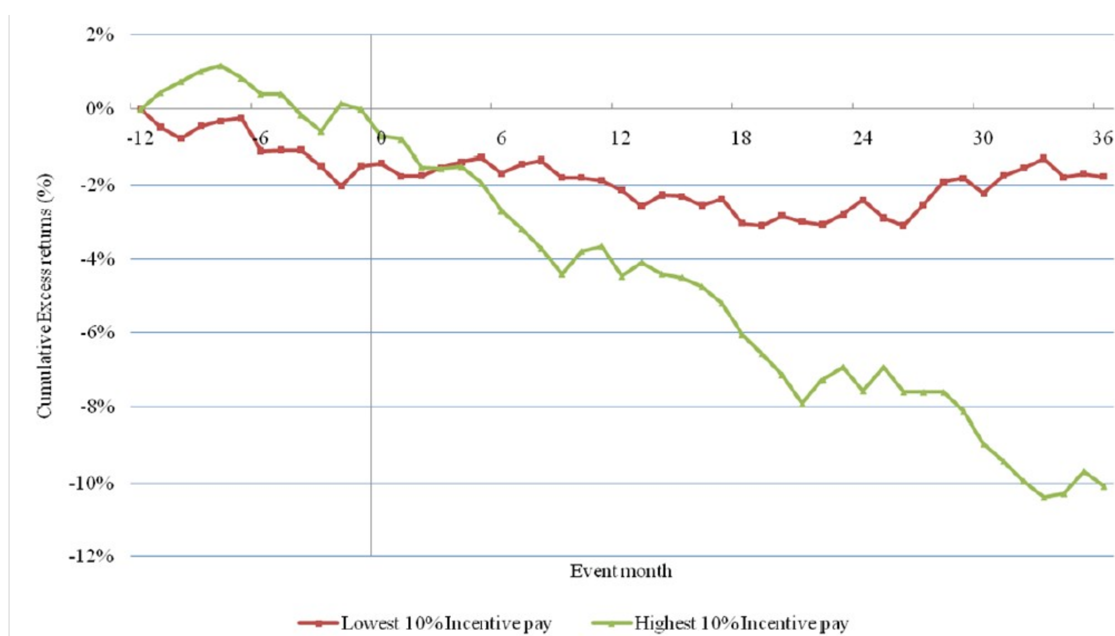

Fig. 5: CEO compensation excess returns (Adjusted for industry and prior year returns)[34]

Bonus

Secondly, Ms. Kinnitt demands a "guaranteed bonus for the first year". In general, the bonus is based on the performance over a year.[35]

Her request for a guaranteed bonus eliminates the basic idea of an annual bonus plan: that pay is related to performance.

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[32] Kostyuk, Stiglbauer and Govorun, 2016, p. 26
[33] Mallin, 2016, p. 234
[34] Rau, 2020, 3/4
[35] Kostyuk, Stiglbauer and Govorun, 2016, p. 26

Moreover, she requests the guaranteed bonus for a duration of one year. Against the background that regulatory bodies restrict "notice periods to less than one year", the guaranteed bonus should be limited to six months.[36] The desired package might lack to be fairly and appropriately constructed by specifically taking into account long-term goals.[37]

Stock options

Ms. Kinnitt's third demand includes "long-term incentives in the form of share options". This should be based on the achievement of agreed earnings-per-share (EPS) performance targets. In general, a stock option gives the CEO the right to buy a share of stocks at pre-specified exercise price for a pre-specified term in the future.

In addition, according to her lawyer, the vesting of the share options should be tied to the profitability of the firm which is measured based on earnings-per-share. Only indexed stock options provide boards the option to reward the CEO for achieving superior returns.[38] Her stock options request is not indexed, instead her stock options are based on the achievement of the agreed EPS performance targets. The performance indicators should incentivise her but also align her interest with those of shareholders to the benefit of the firm long-term[39]. In accordance with the ABI[40] guidelines total shareholder return relative to an appropriate index or peer group should be preferred as generally acceptable performance criterion over accounts-based measures such as earnings per share. Therefore, the package might not be properly related to the corporate performance.[41]

Furthermore, Ms. Kinnitt's lawyer defines the vesting period for two years. With a vesting period of two years, Ms Kinnitt is expected to perform over a short period of time and this is a mismatch with the underlying investor time horizons. Therefore, performance should be

[36] Mallin, 2016, p. 224-225
[37] Mallin, 2016, p. 234
[38] Kostyuk, Stiglbauer and Govorun, 2016, p. 27
[39] Mallin, 2016, p. 234
[40] ABI, 2002, 2005
[41] Sykes, 2002

measured over period of at least three years to try to ensure sustained improvements of financial performance.

As an alternative stock option should be cessed and a five-year restricted shares should be given.[42] A restricted stock entails a period of restriction that means that it does not give up the bargaining power of the board.[43] (See Question 2.) In conclusion, the desired compensation package might incite her to perform over short period of time but this does not match the underlying long-term investor time horizons.[44] On a side note, it might be questionable that the by Ms. Kinnett's defined condition "to grow the market" is appropriate.

Ms. Kinnitt asks the vesting schedule to be designed by an immediate vesting of one third, another one third in one year and one third in two years. In general, vesting schedule should be a quarterly staggered vesting of increasing amounts over this period of time. By giving some portion right away, the compensation committee implements a commitment mechanism.

3. **The purpose of the golden parachute is…**

…in general a special compensation agreement for significant benefits in the case of employment termination. Golden parachutes include for example severance pay, cash bonuses, stock options, or other benefits. In most cases it refers to terminate an employment in case of a merger or takeover. But it also is defined as excessive severance package unrelated to change in ownership.[45]

[42] Mallin, 2016, p. 224
[43] Rau, 2020, 3/4; Rau, 2020, 4/4
[44] Sykes, 2002
[45] Bress, 1987, p. 955-979

Giving a golden parachute to Ms. Kinnitt would hurt the firm because…

…golden parachutes are associated with the seemingly excessive amounts paid to directors who leave the firm after failing to meet their targets. These are seen to be inappropriate because they may reduce the value of the business and threaten jobs of the employees.[46]

In Ms. Kinnitt's case, her lawyer wants to implement a golden parachute. He defines this as a "payment of three years' basic salary" if the firm "is taken over" or of "two years' basic salary" if Ms. Kinnitt is being dismissed "for any other reason".

The first request for a golden parachute when the firm "is taken over" might be justified by the moral hazard target companies' CEOs are concerned with in acquisitions. This means that executives' personal gain from the acquisitions could be offset by the cease of future compensation via an employment termination. But instead, studies showed that this is not the case because if parachute importance increases, acquired shareholder revise a lower takeover premia.[47] In addition, critics claim that golden parachutes are an unjustifiable waste corporate assets and create perverse performance incentives.[48] Furthermore, studies showed evidence that companies who use golden parachute have a lower market value than others and their value declines during and after the implementation of golden parachutes.[49] Therefore, it is not recommendable to implement a golden parachute in the case of a takeover for Ms. Kinnitt.

Secondly, Ms. Kinnitt's request for a golden parachute in the case of being dismissed "for any other reason" seems like the excessive amounts paid to directors who leave the company after failing to meet their targets. This is in general seen as inappropriate because regulatory bodies guidance emphasizes that compensation packages should not commit firms to payments for failure.[50]

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[46] Mallin, 2016, p. 224-225
[47] Fich, Tran and Walkling, 2013; Hartzell, Ofek and Yermack, 2004, p. 37-61
[48] Bress, 1987, p. 955
[49] Bebchuk, Cohen and Wang, 2014, p. 140–154.
[50] Mallin, 2016, p. 224-225

Furthermore, in both cases the requirement of a "three years' basic salary" or a "two years' basic salary" should be limited in accordance with the regulatory bodies "by restricting notice periods to less than one year, capping the level of liquidated damages using phased payments, and limiting severance pay where company has performed poorly".[51]

Finally, Ms. Kinnitt's demand for a golden parachute might act as signalling and could have made her reveal her intentions.[52]

4. **The advantages and disadvantages of using compensation consultants are…**

…amongst others a positive effect on the structure of CEO pay and potential conflicts of interest. On the one hand the role of a compensation consultant is a complex one and on the other side there may be potential conflicts of interests.

The first advantage of consultants is that they influence the structure of the payments of the CEO positively because they favour a compensation based on incentives.[53] Secondly, a compensation consultant is to act as an expert to provide priority data against which company can be benchmarked and influence the choice of the comparators, which itself impacts the level of pay.[54] The third advantage is that they act as liaison and service, an important coral in the communication with institutional investor. Fourthly, remuneration consultants legitimize the decisions of the committee by providing an element of perceived independence.[55]

The first disadvantage is that consultants face conflicts of interest. This can cause them to recommend a higher pay level for the CEO. Studies in the USA and Canada found that if a consultant provides other services to the firm the compensation of the CEO is higher. These studies also found an increase in the CEO payments if the fees of consultants for other services were relatively larger than the fees for the CEO compensation services.[56] A second disadvant-

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[51] Mallin, 2016, p. 224-225
[52] Rau, 2020, 4/4
[53] Voulgaris et al., 2010, p. 511
[54] Bender, 2008
[55] Bender, 2011; Mallin, 2019, p. 247
[56] Murphy and Sandino, 2010, p. 247

age is that CEO pay is positively associate with peer firms that share consultants, with higher board and consultant interlocks.[57] Thirdly, another disadvantage is the questionable independence of remuneration consultants in the consultant-client relations.[58] Fourthly, a similar disadvantage is that companies that use consultants have higher-paid executives. This is caused by the conflicts of interest of remuneration consultants as well as by the composition and complexity of pay.[59] In conclusion, there is growing evidence highlighting the role of consultants in setting the CEO compensation and increasing issues with regards to their independence and impact on executive pay in the case of an offer of other services.[60]

A compensation consultant sets the peer group…

…and therefore, the CEO pay by a self-defined market, consisting of a reference group of peer firms. Compensation consultants provide bot generic pay surveys and specifically tailored surveys.

In Ms. Kinnitt's case, the consultant sets the peer group as "similar sized firms in the S&P 500 that have grown in market share by over 20% in the past year". With this he justifies a higher base salary based on Ms. Kinnitt's objective to increase the firm's size and market share.

There are two issues with how the compensation consultant set the peer group: first the impact of the choice of competitors and second the impact of surveys on the general level of the CEO compensation.

In general, and in this case the choice of comparators is one of the most difficult problems because the committee has to rely on the consultant's direction in framing the data. In this case it seems like that the consultant has chosen inappropriate comparators. The firm in this case is

[57] Conyon et al., 2011
[58] Kostiander and Ikäheimo, 2012
[59] Mallin, 2019, p. 247
[60] Mallin, 2019, p. 247

a financial services company in the mining industry, but the compensation consultant chose with the S&P 500 a general stock market index which measures the 500 large companies listed in the USA.

Furthermore, the peer group of similar sized companies which have already grown their market share might be inappropriate because of the currently smaller scale of the company and it's less risky business model. In total, this leads to an improper selection of peers resulting in an excessive compensation request of Ms. Kinnitt.

In addition, the choice of comparators of the remuneration consultant can be judged in the best case as misleading. In general, these surveys themselves often focus on the upper half of the distribution which in itself is a signalling mechanism.[61]

5. **The compensation committee should respond to the demands…**

…by negotiating the good compensation package outlined in Question 2. This would include the cessation of the stock options and the golden parachute, a generous basic salary, bonus and five-year restricted shares plan.[62]

Firstly, the remuneration committee should agree to the lawyer's demand of a higher base salary, a bonus and five-year restricted shares plan. This would limit Ms. Kinnett to be excessively and underserved compensated.

To establish a negotiation basis, the base salary should be determined by above pay benchmarks based on an appropriate industry salary survey. Consequently, the higher base salary would secure her a constant fixed payment.

In addition, the committee should negotiate the bonus from a guaranteed bonus to an annual bonus plan based on her performance over year.[63] A target bonus should be paid for the achievement of the performance standard which is bound to the achievement of the profitabil-

[61] Bender, 2008; Rau, 2020, 4/4
[62] Mallin, 2016, p. 224
[63] Kostyuk, Stiglbauer and Govorun, 2016, p. 26

ity. Because the firm is in the financial services industry, I would recommend the compensation committee to even compensate for failure by remunerating Ms. Kinnett through a bonus-malus plan.[64]

Furthermore, the committee should offer her a five-year restricted share plan. This means that the remuneration package is related to the corporate performance and it incites her to match the underlying long-term investor time horizons.[65] The restricted stock entails a period of restriction that means that it does not give up the bargaining power of the board. The restricted stock should include a vesting option in five years' time to ensure the long-term incentive. The vesting schedule would be designed as staggered vesting of a quarterly amount of the option for five years.

Secondly, the committee should cease the stock options and the golden parachute. This would properly relate the package to the corporate performance.[66]

Stock options are not related to the corporate performance[67] and could offer her the opportunity to manipulate. Instead of bounding the share options to the achievement of agreed earnings-per-share performance targets, I propose to bound the restricted shares to the total shareholder return. [68]

Moreover, the golden parachute seems to be inappropriate because in the case of takeover the acquired shareholder would revise a lower takeover premium[69] and the financial services industry is in general not prone to takeovers.

[64] UBS, 2013
[65] Sykes, 2002
[66] Sykes, 2002
[67] Sykes, 2002
[68] Mallin, 2016, p. 234
[69] Fich, Tran and Walkling, 2013

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