Giving investors a say on CEO pay limits excesses

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As of Wednesday 4th January, the average FTSE100 CEO had made more money in 2017 than the average British worker will earn all year according to The High Pay Centre, a think tank. Ever since the financial crisis, legislators have moved to address such excesses by making shareholder votes on CEO pay mandatory.

But do such shareholder votes improve CEO accountability and reduce corporate excesses as they set out to? A new paper "Say Pays! Shareholder Voice and Firm Performance" in the *Review of Finance* by Maria Guadalupe, an Associate Professor of Economics and Political Science at INSEAD, shows that they do.

Until now, there has been a lack of evidence on the consequences of adopting say-on-pay beyond the short-term market reaction. Existing research has generally examined the effect of say-on-pay after it has been legislated, which has produced mixed results.

Guadalupe's research takes a different approach to isolate a causal estimate of the effects of say-on-pay. She examines 250 cases of proposals to adopt the say-on-pay policy from shareholders of S&P1500 firms between 2006 and 2010, which was before say-on-pay votes were mandatory.

She finds evidence that say-on-pay has a positive impact on firms' accounting and operational performance in the years following the vote to adopt say-on-pay. Firms that adopt say-on-pay in her sample have a higher return on assets and operating assets one year after the vote was introduced. The firms also saw a reduction in overheads and capital expenditure growth.

Interestingly, she finds no systematic change in the level or structure of CEO compensation itself or the probability of the CEO leaving the firm after a say-on-pay vote. She does find, however, that the say-on-pay increases shareholder value by about 5 percent.

"The say-on-pay changes CEO behaviour through two main mechanisms. First, by giving shareholders a channel to express their opinions, it intensifies board monitoring and pressure on the CEO to improve performance, especially as a negative vote could have consequences on the level of support the CEO receives within the firm. The prospect of a negative vote is also not one the CEO wants to face for the sake of his or her own career. The second is that the say-on-pay can affect the current level and structure of executive pay making it more closely tied with performance," said Guadalupe.

Her study also finds that when shareholders in her sample put forward proposals to adopt say-on-pay, in 99 percent of cases, boards recommended a vote against it at shareholder meetings. This, Guadalupe said, represents a misalignment of objectives between management and shareholders that mandatory say-on-pay votes can address.

"While the debate has moved on to whether to make say-on-pay votes binding, for which we have no evidence to support or dispute, it is clear that legislative intervention has addressed a market failure on two dimensions; first, aligning management closer to shareholders and second, giving all shareholders an equal voice," she added.

More information: Vicente Cuñat et al, Say Pays! Shareholder Voice and Firm Performance, *Review of Finance* (2016). DOI:

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