

Asymmetric Benchmarking in Compensation: Executives are Paid for (Good) Luck But Not Punished for Bad

Abstract

Principal-agent theory suggests that a manager should be paid relative to a benchmark that captures the effect of market or sector performance on the firm's own performance. A long-standing empirical puzzle is the apparent absence of such indexation in actual executive compensation. Recently, it has been argued that this puzzle reflects executives' ability to set pay in their own interests; since markets tend to rise, top managers will more often than not enjoy compensation windfalls. We first show that this argument is flawed. The positive expected return on stock markets reflects compensation for bearing systematic risk. If executives' pay is tied to market movements, they will receive the market-determined expected return for risk-bearing. We then reformulate the argument in a more appropriate fashion. If managers can truly influence the nature of their pay, they will seek to have their pay benchmarked only when it is in their interest, namely when the benchmark has fallen. Using a variety of market and industry benchmarks, we find that there is essentially no indexation when the benchmark return is up, but uncover substantial indexation when the benchmark has turned downwards. These empirical results are robust to a variety of alternative hypotheses and robustness checks, and suggest an increase in expected direct compensation of approximately \$75,000 for the median executive in our sample, or about 5% of total compensation.