Chapter 9: Conclusion

9.1 Scope and Key Results

In this dissertation, four key research issues have been examined empirically. First, do Indian private sector companies use RPE in setting total CEO’s compensation? Second, do Indian private sector companies with lower operating profitability and asset utilization efficiency use more RPE? Third, what ownership and board factors are associated with CEO compensation in Indian companies? Fourth, does CEO compensation reflect CEO entrenchment or efficient compensation contracting in Indian companies? We document several interesting results.

First, the boards of private sector companies in India determine their CEO’s total compensation using RPE. They do so by placing a positive weight on the firm’s own performance and a negative weight on the company’s peer performance. Contrary to the practice of using stock returns as the measure of firm performance in the U.S. and the U.K., the boards of Indian private sector companies employ an accounting measure of firm performance to benchmark a firm’s performance with its peers’ performance. This is the first study in the Indian setting to provide these insights.

Second, RPE usage and the weight on peer performance are associated with a company’s operating efficiency and asset productivity. Indian firms with poorer operating margin and asset turnover ratios use more RPE, and they do so by putting a more negative weight on peer performance. Therefore, RPE usage in CEO compensation is determined by a firm’s strengths and weaknesses as reflected in the drivers of operating efficiency and asset productivity. To the best of our knowledge, this is the first study to provide these insights.
Third, total CEO compensation is associated with a firm’s ownership structures, but not its board structures. This is the first study in the Indian setting to provide this insight. We find that total CEO compensation increases with institutional ownership, but decreases with the number of blockholders. Unlike prior compensation studies in the Indian setting, our results show that CEO compensation does not exhibit a significant association with corporate governance attributes, such as promoter shareholding, board size, and proportion of independent directors in the board. Unlike prior studies, we do not find that CEO compensation is significantly higher in firms affiliated to a business group or with fewer independent directors or more busy directors and for a CEO belonging to the promoter group or holding the board chair. Therefore, powerful CEOs do not collude with their board to draw higher compensation. Further, our results highlight the importance of controlling for unobserved CEO talent in compensation regressions and clustering standard errors by firm in longitudinal compensation studies; one or both of these are lacking in prior longitudinal compensation studies on Indian firms. Therefore, our study overcomes methodological issues affecting the results documented in prior compensation studies on Indian firms. It extends Graham et al. (2012) by showing that the magnitude and significance of ownership and board attributes change when CEO fixed effects are included. We also document that the drivers of total compensation differ across the public and the private sector. In particular, the pay-for-performance-sensitivity is significantly positive in the private sector, but insignificant in the public sector. This is the first study in the Indian setting to provide these insights.

Fourth, we document evidence that suggests that the explanation for excessive CEO compensation is not rent extraction by the CEOs, and therefore, does not indicate a failure of corporate governance mechanism in Indian companies. Rather,
higher compensation reflects efficient compensation contracting. This is the first study in the Indian setting to provide insights related to the explanation for excess compensation.

9.2 Implications of the Study and Policy Recommendation

Prior studies in the Indian setting suggest CEO compensation contracting is inefficient, boards are ineffective in monitoring CEO compensation, and powerful CEOs indulge in rent extraction, consistent with managerial power theory. In contrast, our results suggest that powerful CEOs do not collude with the board to draw excess compensation, boards use RPE in determining total CEO compensation and more so in firms that have lower operating efficiency and asset productivity. The evidence suggests that CEO compensation contracting is efficient and consistent with human capital theory and stewardship theory. The results of this study will be of interest to researchers, remuneration committee members, shareholders, and regulators.

9.2.1 Implication for Researchers

The results show the importance of controlling for unobserved CEO talent and clustering standard errors by firm in longitudinal compensation studies in the Indian setting; one or both of these are lacking in prior longitudinal compensation studies on Indian firms.

Inadvertently leaving out CEO fixed effects, a proxy for a CEO’s unobserved innate ability, exposes a longitudinal compensation study to omitted variable bias because CEO talent is correlated not only with CEO compensation but also with several firm characteristics including firm size and profitability. As a result, OLS regressions yield inconsistent estimates of the coefficients on explanatory variables.
Including CEO fixed effects overcomes the issue. Most statistical software allow for fixed effect in a regression with minimal incremental effort.

The results show that the determinants of CEO compensation differ across the subsample of public sector and private sector firms in India. For example, CEO compensation is associated with the number of blockholders, the shareholding of institutional investors, firm performance, and firm age in private sector firms, but not in public sector ones. In contrast, CEO compensation is associated with the proportion of independent directors on the board and firm’s risk in public sector firms, but not in private sector ones. Since public sector observations are relatively much lower in number than private sector observations, pooling the two subsamples together to understand the determinants of CEO compensation erroneously suggest that compensation is associated with a firm’s risk, in an average firm. Therefore, it is best to keep the two subsamples separate in compensation studies in the Indian context.

Longitudinal studies have several observations per firm. Observations across years for a firm have a common data generating process and their residuals are correlated. Therefore, they violate the critical assumption of independence of residuals across observations in OLS regressions. When residuals are serially correlated for a firm, standard errors are usually biased downward causing t-statistics to be biased upward. As a result, failure to use clustered standard errors leads to inflated significance of key variables in longitudinal compensation studies. Most statistical software, such as Stata, SPSS, and SAS, are capable of providing clustered standard errors with minimal incremental effort.
9.2.2 Implication for Regulators and Board of Directors

The study shows a significantly positive pay-for-performance sensitivity for private sector CEOs but an insignificant one for public sector CEOs. This indicates that private sector CEOs are rewarded through higher compensation for achieving greater profitability. An increase of 100 basis points in the ROA of a private sector firm translates to about 2% higher total CEO compensation, on average. In contrast, CEOs of public sector firms are not adequately incentivized to enhance their firm’s profitability. The insight is timely and relevant given the effort made by successive governments to make public sector company CEOs accountable and the firms performance-oriented. Insignificant pay-for-performance sensitivity for public sector CEOs highlights the need to improve their compensation contracting, performance standard setting, and evaluation processes.

This study provides evidence that compensation contracting is efficient in private sector firms. Total compensation for private sector CEOs is based on relative performance evaluation, and on average, private sector CEOs do not exhibit managerialism. Therefore, various changes in corporate governance norms introduced by the Indian government, the SEBI, and the RBI, have worked towards making CEO compensation contracting process efficient. However, the existing disclosure requirement for CEO compensation contracting process is rather limited in scope and there is potential for their enhancement. For example, companies in the U.S.A. are required to disclose how their board evaluated the performance of their firm’s CEO, which specific metrics were used, how these were computed, what performance standards were used, how annual and long-term incentives were computed, what was the fair value of equity-based pay, whether they took the assistance of compensation consultants in compensation benchmarking, etc. Such enhanced disclosure by Indian
companies will increase transparency in CEO compensation contracting and facilitate greater scrutiny and monitoring by blockholders, minority shareholders, analysts, and media. Greater disclosure will also help companies learn from each other and incorporate better practices in CEO compensation contracting.