

Corporate Governance and the Future of Proxy Advising



To view Alexander's Wagner profile, please visit www.sfi.ch/wagner.

Alexander Wagner is an Associate Professor of Finance at the University of Zurich. He joined SFI in 2006 and has held an SFI Junior Chair since 2012. He obtained his PhD in political economy from Harvard University in 2005. His research has been published in leading academic journals and his main research interests are executive compensation, corporate governance, and behavioral economics. Wagner is a board member of SWIPRA and an independent counsel for PricewaterhouseCoopers.

Executive Summary

In this issue of SFI Insight, Wagner shares his industrial and academic views on executive compensation and corporate governance. He talks about where the future of proxy advising lays and the evolving requirements from shareholders. His work with a proxy advisor entails knowledge transfer from his academic work. An article recently published in the Journal of Finance is an example of this connection. In this particular article, Wagner and his co-author make the simple point that forced turnover risk explains an important part of compensation for CEOs of US public corporations: the empirical magnitude of the turnover risk premium is of about 7% greater compensation for a 1% point increase in turnover risk (see page 2 for the full summary).

Proxy Advising on the Rise in Switzerland and the Case of SWIPRA

The role of proxy advising in Switzerland is on the rise as the Ordinance against Excessive Compensation with respect to Listed Stock Corporations, which implements the Minder initiative, came into force at the beginning of 2014. Among its effects, the Ordinance requires that at each general meeting i) the shareholders elect the individual members of the compensation committee, and ii) the shareholders vote, in a binding manner, on the annual compensation of both the executive board and the board of directors. Moreover, iii) Swiss pension funds have to exercise their voting rights on many agenda items. They have to do so in the interest of the insured and have to document their voting behavior.

SWIPRA, a Swiss-based proxy advisor, is currently providing shareholders of the 50 most highly capitalized corporations listed on the SIX Swiss Exchange (SMI Expanded®) with voting recommendations for annual general meetings. Voting recommendations are established on a principle-based approach and refer to economic and empirical evidence relating to corporate governance. The primary economic analysis is conducted by researchers at the Department of Banking and Finance at the University of Zurich. An additional cooperation agreement with a chaired professor at the Department of Law ensures the quality of the advice in legal respects. Debatable items are clarified with the firm, and clients receive both SWIPRA's final recommendation, with the corresponding reasoning, as well as the company's response.

For more detailed information, please visit swipra.ch/en/



SWISS PROXY ADVISOR
FOUNDATION FOR VALUE
BASED INVESTMENTS

Wagner (SFI@UZH) is a member of the board of trustees of SWIPRA, a non-profit oriented, independent proxy advisor for institutional investors with registered offices in Zurich, and a Foundation under Swiss law. He gives us his insights on corporate governance and the future of proxy advising.

What is the general attitude from companies with respect to the work that proxy advisors conduct?

Generally speaking, companies have two concerns: First, they see some established proxy advisors as potentially poorly informed and as too dogmatic in their voting recommendations. Second, they worry about conflicts of interests of some of the existing proxy advisors. Therefore, SWIPRA's unique process, by which recommendations are developed independently based on academic research and by which SWIPRA's CEO clarifies debatable items with the companies, is valued by companies.

Who are your clients and how do they perceive SWIPRA's recommendations?

Our clients are both Swiss and international institutional investors, and the portfolio is growing continually. Originally, we targeted mostly Swiss pension funds, but it turns out that international asset managers are also quite interested. Overall our clients appreciate the fact that SWIPRA provides an academic-based company-specific analysis rather than a simple checklist analysis and that those companies have the ability to defend their own recommendations. Generally speaking, our clients are appreciative of the fact that competition among proxy advisors probably improves quality of the advice.

By what extent do the recent regulatory decisions help proxy advisors accomplish their tasks?

On the one hand, more disclosure requirements, for example, regarding executive compensation for companies mean that proxy advisors can provide better-informed recommendations and shareholders can take better-informed decisions. On the other hand, regula-

tion is also relevant for proxy advisors themselves. Both the EU and US regulators have recently begun to push for additional disclosure regarding possible conflicts of interest of proxy advisors, regarding both the actual basis for voting recommendations and the process by which these recommendations are established. Credit rating agencies used to be powerful and well regarded institutions, but increases in potential conflicts of interests have somewhat changed the picture in recent years. I think, therefore, that the recent push to provide some regulatory framework for proxy advisors makes sense.

Where does the future lie for proxy advisors?

Proxy advisors have a significant responsibility and they should act accordingly. A bright future lies ahead for those proxy advisors that explain their decisions and maintain high standards of corporate governance.

SFI NEWS

Upcoming Events

10.11.2014
Lunch & Learn @ SFI;
Informationsveranstaltung, Zurich

13.11.2014
9th Annual Meeting - People or
Technologies: Where to Invest
for the Future of Swiss Banking?

For more information on upcoming events: www.SFI.ch/Events

SFI Faculty Changes

Boris Nikolov has been hired as a tenure-track assistant professor of finance by the University of Lausanne. Boris arrives from the University of Rochester and graduated from the SFI Léman Center in 2008.

Philip Valta has been hired as a tenure-track assistant professor of finance by the University of Geneva. Philip arrives from HEC Paris and graduated from the SFI Léman Center in 2010.

The Executive Turnover Risk Premium



Introduction

In a recently published article in *The Journal of Finance*, Alexander Wagner (SFI@UZH) and his co-author Florian Peters (University of Amsterdam and PhD@SFI), tackle the question of the executive turnover risk premium. By giving a financial touch to the classical economic wage equation they provide us with a new understanding of the determinants of executive compensation. In light of the ongoing debate about executives' pay practices and observed increases in wage inequality, in both the USA and Europe, understanding the executive labor market is of prime importance.

Motivation and Research Question

The authors' main motivation is to investigate whether the risk of being fired is priced in executive compensation. Prior research shows that CEOs bear high firing costs, remain unemployed during extended periods of time, generally end up working in a smaller firm, and earn a lower salary. A competitive labor market would thus require financial compensation to bear such a turnover risk. By contrast, if CEOs are mostly entrenched and set their own pay, they would enjoy both high job security and high pay, that is, there would be a negative relation between turnover risk and compensation.

Empirical Approach

An obvious causality problem arises when one wishes to determine the effect of turnover risk on compensation. To circumvent this challenge, the authors run a two-stage regression and estimate job risk in the first stage, and the impact of predicted job risk on compensation in the second stage.

In short, the authors hypothesize that a higher industry risk should predict a higher forced turnover probability; a CEO may be fired because the industry in which he works has changed due to an exogenous technological shock. To determine industry changeability, the authors use measures of industry-level equity volatility and industry long-term credit ratings. A higher forced turnover probability should in turn require higher compensation.

Data

The bulk of the data comes from the Execucomp database. Identifying the true reason for an executive turnover is challenging, as firms rarely announce a turnover as being involuntary. To tackle this issue, the authors rely on two different methods. The first uses an algorithm based on press reports and age to determine whether the turnover is voluntary or not; the second is based solely on the CEO's age at the time of departure. Importantly, compensation is estimated in both an objective and a subjective manner, where the latter approach accounts for risk aversion of the CEO and the under diversification of a CEO's portfolio.

The data spans from 1993 to 2009, covers exclusively publicly traded US firms, and yields 3'360 turnovers, of which 799 are classified as forced, out of a total of 29'211 observations. Median total compensation is of approximately USD 2.2 million, median age is 55, and median firm total asset values are USD 1.5 billion. Industry stock return volatility is 23% on a monthly basis and the S&P average credit

rating is BBB, the lowest credit rating in the investment grade category.

Empirical Estimation

The first-stage results show that higher industry risk indeed induces a higher probability that a forced turnover occurs. These results hold controlling for a large set of variables such as idiosyncratic stock return, CEO age, CEO tenure, etc.

In the second stage estimates, the authors determine the CEO's compensation using the estimated probability of the CEO being fired estimated in the first stage. The results show that there is a robust and positive relationship between predicted turnover risk and associated CEO compensation even when taking variables such as firm size, corporate governance, CEO's skill, age, and experience into account. The empirical magnitude of the turnover risk premium – about 7% greater subjective compensation for a one percentage point increase in turnover risk – is in line with calibrated theoretical predictions.

Conclusion

Part of the literature on CEO compensation argues that pay is largely determined by market forces, another part argues that CEOs may be entrenched within a firm, and may be able to set both their pay and job security. The results of this paper suggest that, at least with respect to the relationship between pay and turnover risk, market forces prevail.

To download the full paper, please visit [The Journal of Finance](#) or [SSRN](#).

Forthcoming A-Publications

Endogenous Dividend Dynamics and the Term Structure of Dividends Strips, F. Belo, **P. Collin-Dufresne**, and R. S. Goldstein, *Journal of Finance*.

Preemptive Bidding, Target Resistance and Takeover Premiums, **T. Dimopoulos** and S. Sacchetto, *Journal of Financial Economics*.

Structured Debt Ratings: Evidence on Conflicts of Interest, **M. Efung** and **H. Hau**, *Journal of Financial Economics*.

Asset Pricing with Arbitrage Activity, **J. Hugonnier** and R. Prieto, *Journal of Financial Economics*.

Capital Supply Uncertainty, Cash Holdings, and Investment, with **J. Hugonnier**, **S. Malamud**, and **E. Morellec**, *Review of Financial Studies*.

Collateralization, Bank Loan Rates and Monitoring, G. Cerqueiro, **S. Ongena** and K. Roszbach, *Journal of Finance*.

Stock Investments at Work, H. Hvide and **P. Östberg**, *Journal of Financial Economics*.

The Dynamics of Innovation and Rents, B. Biais, **J.-C. Rochet** and P. Woolley, *Review of Financial Studies*.

Opacity in Financial Markets, **Y. Sato**, *Review of Financial Studies*.

A Polynomial Optimization Approach to Principal-Agent Problems, **K. Schmedders** and P. Renner, *Econometrica*.

Generalized Risk Premia, **P. Schneider**, *Journal of Financial Economics*.

Are Institutions Informed about News?, T. Hendershott, D. Livdan, and **N. Schürhoff**, *Journal of Financial Economics*.

Impressum

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