# GOVERNANCE STRUCTURE AND THE COMPENSATION OF BANK CEOS

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## ABSTRACT

Both the levels of corporate CEO pay and whether it represents pay for performance are controversial topics. Weaker governance structures should be associated with excessive pay or weaker links between pay and performance. We use a sample of 93 publicly-traded bank holding companies to test whether corporate governance variables affect CEO compensation. Our results using data for 2001 demonstrate that after controlling for economic factors, several governance variables, including CEO ownership, block-holder ownership, and director ownership, have a significant influence on the compensation of bank CEOs.

## INTRODUCTION

CEO compensation is a topic of enormous interest and controversy in both academic research and the business press. The ratio of CEO pay to the pay of the average worker has risen from 24 in 1965 to 260 in 2005 [21]. Moreover, some academic research documents a relatively weak linkage between firm performance and CEO pay [18]. Recently a number of studies have examined whether noneconomic factors help determine CEO pay, focusing on the corporate governance characteristics of firms [7][12][19]. The majority of these studies use data from industrial firms, either eliminating financial firms from their samples, or not reporting the results for banks and bank holding companies. Thus, we know very little about how governance structure influences the compensation of the CEOs of banks and bank holdings companies. In this study we examine the role of governance structure in determining the compensation of bank CEOs, using data for 93 large bank holding companies operating during 1999 to 2001. We focus on governance characteristics of banks for several reasons. The new Basel II requirements place a much greater emphasis on corporate governance to reduce operational risk for the banking industry. Institutional investors have become more interested in the governance structure of banks particularly the business relationships between bank managers and some outside board members. With changes in regulations and markets, internal governance structures will play an increasing role in bank performance. We examine how bank boards remunerate the CEO, an area in which weak governance might exhibit itself, providing insight into the efficacy of bank governance.

## OVERVIEW OF THE LITERATURE

The literature examining the effectiveness of board of directors in monitoring managers, establishing executive compensation, and protecting shareholders' interests has often focused on how effective board of directors are and on how corporate governance problems may reduce this effectiveness [11] [18] [28]. As noted by Brick, Palmon, and Wald [6], several studies find evidence consistent with Jensen's [16] argument that boards often are ineffective in monitoring managers, as the result of information asymmetry problems and board cultures that discourage criticism. Large boards and the existence of gray, overly busy, and interlocked directors have been associated with weaker monitoring, lower firm

performance, and high CEO compensation, supporting this premise [12] [14] [20] [28]. Greater management participation in board of director selection has also been associated with a lower proportion of outside directors [23], although other studies suggest a negative effect when CEO's are not involved in director nominations [10]. Tenure may also affect board independence, with a finding by Vafeas [26] that when CEOs are powerful, they generally have higher pay when board members have tenure of 20 or more. Brick, Palmon, and Wald [6] examining the relationship between excessive CEO and director compensation for non-financial firms during 1992 to 1997 find a positive association. Uzun, Szewczyk, and Varma [25] examine board of director characteristics for matched pairs of non-financial firms involved or not involved in corporate fraud during 1978 to 2001, and find the likelihood of fraud to fall as the fraction of independent directors rises. Also, smaller boards and boards with fewer grey directors were less likely to be involved in fraud.

Only a few studies examine corporate governance structure and CEO compensation for bank holding companies (BHCs) and not for recent years, when banks have been using more performance-based compensation [5] [15]. Mishra and Nielsen [22] examine the relationship between board independence and CEO pay-performance sensitivity for 89 large BHCs operating in 1990. They find CEO pay for performance sensitivity to rise as the percentage of independent directors on a board rises. However, the percentage of independent directors is also negatively related to accounting performance measures, consistent with findings of earlier studies by Agrawal and Knoeber [1] and Subramanyam, Rangan, and Rosenstein [24]. Whidbee [27] examines board of director structure for 190 large publicly-traded bank holding companies in 1991, and find BHCs with larger CEO ownership to appoint fewer independent directors, while BHCS with larger institutional ownership had a greater number of independent directors. Angbazo and Narayanan [2] examining 97 US banks operating in 1989 find that the mix of a CEO's compensation in terms of fixed and equity-based pay is a positive function of director tenure and busy directors serving on more boards. Our study expands on the previous literature by examining how governance structure affects the levels of CEO compensation using more recent data for large BHCs.

## DATA, METHODOLOGY, AND HYPOTHESES

### Data

The sample consists of 93 publicly-traded depository institutions (86 bank holding companies and 7 large thrift holding companies) operating in 1999 to 2001, prior to a bank consolidation wave that occurred after 2001, including all depository institutions with detailed director information listed on the Corporate Library database with proxy statement data available on directors from the SEC for 2001, as well as detailed executive compensation data and peer bank compensation data in the SNL Compensation Reviews for Bank and Thrifts. An advantage of our sample is that it includes large, publicly-traded firms operating in the banking industry, providing greater homogeneity in business lines and a less biased comparison of compensation relative to market value across the sample. The sample includes relatively large bank holding companies with an average asset size of $51.517 billion, (median $10.176 billion, and range from $2.358 billion to $1,051.5 billion). The average CEO compensation during 1998 to 2000 is also large, with a mean of $2.399 million, with a large range of $.388 million to $23.287 billion. The mean percentage of independent directors is 72 percent (range from 27 to 100 percent). The mean board size is 14 (range from 6 to 30 members). On average 76 percent of CEOs serve as chairman of the board, and 66 percent of the banks in the sample have staggered boards. CEO's own on average 2.76 percent of the firm's equity, while all inside managers own on average 9.59 percent, and block-holders own on average 6.59 percent. The average three year stock return for the sample during this robust market period was 32.6%, (range from -66.4 percent to

346.5 percent). In terms of tenure, the median and average tenure for the board is 9.6 for outside directors (maximum 21, minimum 2 years).

## Hypotheses and Methodology

We test alternative hypotheses on the effect of different corporate governance variables on CEO compensation including a number of different corporate governance variables and economic control variables. We estimate a generalized least squares (GLS) model adjusting for heteroscedasticity as:

$$\text{CEO Pay} = f\,(\text{Governance Variables, Economic Control Variables}) \qquad (1)$$

CEO Pay is the average compensation paid to the firm's CEO over 1998 to 2000. Economic control variables include: (1) Firm Size (SIZE), which serves as a proxy for the complexity and responsibility of a CEO, with larger firms expected to pay more; (2) Previous Stock Price Performance for the BHC (BKRET), the average stock return for a BHC over the past three years, with CEOs expected to have higher pay for higher performance; (3) Previous Peer Stock Price Performance (PEERRET), the average stock return for Peer Banks over the past three years, with compensation expected to be tied to a Peer return benchmark. Governance variables we examine include: (1) CEO Stock Ownership (CEOWN), the percentage of a firm's equity owned by the CEO, which is expected to be positively related to CEO compensation [17]; (2) Director Stock Ownership (DIROWN), the percentage of a firm's equity owned by directors, which is expected to be negatively related to CEO compensation if stock ownership improves monitoring by directors; (3) Block-holder ownership (BLKOWN), the percentage of equity owned by large outsiders that have a strong incentive to monitor managers, expected to be associated with lower CEO pay; (4) Staggered Board (STAGBD), an indicator variable if a firm has a staggered board making it more difficult for dissident shareholders to replace managers, suggested to be positively related to CEO pay; (5) Board Interlocks (INTLOCK), an indicator variable equal to 1 if the CEO serves on any of the directors' boards, expected to be positively related to CEO pay; (6) Board Size (BDSIZE), the average board size of a BHC, with larger size expected to result in lower monitoring, suggesting a positive relationship with CEO compensation; (7) Director Independence (INDEP%), the percentage of independent directors, as used in previous studies of nonfinancial firms [4] [9] [8] [13], suggesting that CEO pay will be lower with a larger percentage of resulting in better monitoring; (8) Median Director Tenure *(MEDTEN)*, the median number of years for a bank's directors, reflecting a director's relationships with the CEO, which may reduce independence, suggesting a positive effect on CEO pay [3] [26]; (8) Percentage of Outside Directors (OUTDIR%), the percentage of outside directors on the board suggested to be negatively related to CEO pay; and (9) CEO Tenure (CEOTEN), the tenure of the CEO, with longer tenured CEOs likely to have greater power over compensation, a positive relationship would be expected. We also examined other board structure variables suggested in other studies, which were consistently insignificant, so excluded from the models shown in the following empirical results section.

## EMPIRICAL RESULTS

Table 1 shows the empirical results for the regression models. As noted by the high R-squares and F-statistics for the models, the models demonstrate a good fit. Different models are shown to test the sensitivity of the results when variables are excluded.

**Table 1: Results: Average CEO Compensation Regressed on Governance Variables**

| | Model 1 | Model 2 | Model 3 | Model 4 |
|---|---|---|---|---|
| **SIZE** | **0.0165** | **0.0165** | **0.0167** | **0.0167** |
| t-statistic | 6.63 *** | 6.82*** | 6.98*** | 7.02*** |
| **BKRET** | **3463.821** | **3599.676** | **3584.966** | **3469.52** |
| t-statistic | 1.67* | 2.13** | 2.12** | 2.10** |
| **PEERET** | **0.4177** | **0.4056** | **0.4192** | **0.4242** |
| t-statistic | 1.42 | 1.37 | 1.46 | 1.45 |
| **CEOWN** | **4055396** | **3997890** | **4307048** | **4092674** |
| t-statistic | 2.02** | 2.54*** | 3.01*** | 2.98*** |
| **DIROWN** | **-1972522** | **-1958482** | **-1829005** | **-1789354** |
| t-statistic | -1.67* | -1.80* | -1.72* | -1.69* |
| **BLKOWN** | **-2458628** | **-2448960** | **-2373062** | **-2349113** |
| t-statistic | -3.29*** | -3.19*** | -3.49*** | -3.47*** |
| **STAGBD** | **-162077.8** | **-169928.2** | | |
| t-statistic | -0.38 | -0.45 | | |
| **INTLOCK** | **-877519.2** | **-877340.4** | **-932669.8** | **-917515.1** |
| t-statistic | -1.13 | -1.20 | -1.26 | -1.25 |
| **BDSIZE** | **494.9047** | | | |
| t-statistic | 0.02 | | | |
| **INDEP%** | **330334.3** | **321048.1** | **327511.7** | |
| t-statistic | 0.36 | 0.38 | 0.39 | |
| **MEDTEN** | **54433.56** | **54276.39** | **54006.84** | **53083.75** |
| t-statistic | 1.36 | 1.53 | 1.52 | 1.53 |
| **OUTDIR%** | **420368.1** | **421958.5** | **452356.3** | **450589.6** |
| t-statistic | 0.80 | 0.82 | 0.87 | 0.87 |
| **CEOTEN** | **-255.5605** | | | |
| t-statistic | -0.01 | | | |
| **CONSTANT** | **-351790.9** | **-294173.4** | **-464227.7** | **-234540.2** |
| t-statistic | -0.30 | -0.32 | -0.58 | -0.41 |
| **No. of Obs.** | **93** | **93** | **93** | **93** |
| **F-statistic** | **15.1*** ** | **18.18*** ** | **20.25*** ** | **20.85*** ** |
| **R-squared** | **0.8270** | **0.8270** | **0.8265** | **0.8263** |
| | | | | |

T-statistics are corrected for heteroskedasticity using White's method are shown below each coefficient, with ***, **, * indicating significance at respective .01, .05, and .10 levels. SIZE is the log of assets (bils.). BKRET is the average bank stock return for the past three years. PEERET is the average stock return for a BHC's peer bank group. CEOWN is the fraction of stock owned by the CEO. DIROWN is the fraction of ownership by directors. BLKOWN is the fraction of ownership by blockholders. STAGBD is an indicator variable, equal to 1, if the board is staggered, 0, otherwise. INTLOCK is an indicator variable, equal to 1, if a BHC has interlocking directors. BDSIZE is the number of directors on a board. INDEP% is the fraction of independent directors. MEDTEN is the median tenure for the board. OUTDIR% is the fraction of outside directors on a board. CEOTEN is the tenure of the CEO. Constant

is the intercept term.

For Model 1, which includes all independent variables, consistent with previous studies, compensation is performance-related with a significant positive coefficient on BKRET, a bank holding company's average three year stock return. However, the coefficient on PEERET, the average Peer stock return is insignificant. CEO compensation is also significantly higher for large firms, with a significant positive coefficient on SIZE (asset size in billions), consistent with previous studies examining non-financial firms. For model 1, several corporate governance variables are also significant. Ownership variables are particularly significant, including the percentage of CEO ownership (CEOWN), with a positive coefficient. As CEO ownership rises, so does CEO compensation. This result is consistent with the hypothesis of greater CEO stock ownership providing greater control for the CEO over compensation. In contrast, the coefficients on DIROWN, the percentage of director stock ownership, and on BLKOWN, the percentage of block-holder ownership, are negative and significant. This supports the hypothesis that greater outside and director ownership results in better corporate governance.

As noted in columns 2 to 4, these results are consistent across different models. The coefficient on other board characteristic variables, appear to have little effect on CEO compensation, with ownership variables dominating as corporate control devices. The results are for one point in time, they suggest that ownership characteristics provide greater incentives for monitoring by directors versus other board characteristics.

## SUMMARY AND CONCLUSION

This research examines the relationships among different corporate control variables and compensation of CEOs for large bank holding companies operating during 1998 to 2001. Our results suggest that ownership variables dominate, while other board structure variables are insignificant, in terms of having a significant effect on CEO compensation. Whether the results carry over to a broader sample of firms and across other time periods requires further examination.

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