

(Re)-structuring the CEO's compensation—the case of Israel¹

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Abstract: The executive compensation issue continues to cause protest due to the increasing number of cases of an unjustifiably high level of pay. The main conflict arises from the misalignment of interests between the short-term expectations of the manager and long-term needs of the shareholders. Since there are no universal rules on how to price the executive performance companies reach for different means of establishing the CEO's compensation and ascertaining manager's commitment towards maintaining a company's value. The issue becomes more complex once the compensation rules are not a direct effect of the market power game but are additionally restricted by government. The aim of the paper is to discuss corporate government policies introduced in Israel and their impact on executive compensation level and structure. Israel is amongst those countries that partially regulate CEO compensation and thus the Israeli experience can add to the understanding of the effectiveness of modern corporate governance.

Keywords: CEO compensation, inequalities, compensation gap, agency theory, principal-agent conflict, corporate governance.

JEL codes: K12, G32, G34.

Introduction

The level and way of establishing a CEO's remuneration has been a bone of contention for decades. Since no golden rule has so far been found different countries refer to their own governance policies which are either formally approved or constitute an informal but accepted set of regulations. Nevertheless the issue remains and will remain troublesome as long as the extreme level of compensation discrepancies between the CEOs and mid-level and low-level

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workers prevail. The Financial Times 2019 report on CEO compensation revealed that the gap is actually increasing with an average CEO earning in the USA 254 times more than a median worker (Edgecliffe-Johnson, 2019). The USA is definitely the leader in pay inequalities however they are closely followed by Germany, UK, Canada and the Netherlands. An attempt to regulate executive pay has long been desired by both trade unions and policy makers.

Recent studies have shown that the CEO pay ratios have little to do with the company performance. In fact many studies indicate that neither do they refer to the human and social capital of the CEO. Therefore it is more and more frequently advocated that executive compensation be limited. However concern is voiced mostly in times of crisis (e.g. 2009+ financial crisis) and forgotten in times of prosperity (cf. Letza, 2017).

The aim of this study is to analyze the CEO compensation trends in Israel. Israel's corporate governance has been mostly based on the Anglo-Saxon model however some major changes concerning the CEO's position have been introduced. The paper focuses on the situation before and after the December 2012, 20th company law amendment which highly influenced the payroll establishment system. The study indicates the changes in public industrial companies listed on the Tel-Aviv stock exchange. The remainder of the paper is structured as follows. Firstly, agent–principal conflict is described as the framework for establishing executive payroll. Secondly, the most important features of the Israeli corporate governance system with particular focus on the obligatory remuneration committee establishment are presented. Next, the most recent trends in CEO compensation levels are discussed. Moreover the impact of company law amendments on the CEO compensation trends are highlighted. Finally it is indicated how the main features of the Israeli case apply to global corporate governance regulations.

1. Beyond agency theory—the conceptual frameworks for establishing CEO remuneration

Oliver Hart's and Bengt Holmstrom's Nobel Prize of 2016 concerned the contract theory. They contributed to economics—widely understood—by stressing the meaning of contractual arrangements in solving conflicts of interests. One of the main conflict of interests known in a company is the principal–agent relationship. The principal or the owner of the company employs an agent or the manager to run the firm. This happens once the size and complexity of the tasks performed in the company exceed the capabilities of the owner to run it himself/herself. With the increase in company size and operational scope one normally does not deal with a single owner but with a number of shareholders. Naturally, although the general goal of both remains the company's good

performance the agent tends to adopt the short-time perspective, whilst the principal will be more interested in the long-term outcome. This difference in perspective is what literature refers to as the principal–agent conflict. There are three fundamental behavioural assumptions that underlie the relationship: both parties act in a rational way and are self-interest driven whilst the agent is both effort and risk averse (Baiman, 1990; Bloom & Milkovich, 1998; Jensen & Meckling, 1976; Saha & Kabra, 2019).

One of the ways of minimizing the risk of a misalignment of interests are contractual provisions, especially in the CEO's compensation structure (Holmstrom, 1979, 1982). The idea is to make the agent pursue company long-term enhancement. It is generally done by fixing the compensation with the company's share value (more on the compensation components can be found in Section 2). The agent should be interested in increasing the share value since a certain amount of time needs to elapse before the CEO can vest the shares. There is however no consensus on an ideal compensation structure as individual countries apply different corporate policies. Generally a trend towards increasing the equity-based component can be observed.

Another perspective on the agent–principal nexus is the value maximization theory. According to the concept the contractual arrangement between the CEO and the owner is optimal and any external restrictions will cause it to become suboptimal. The assumption of optimality is based on the fact that if the expectations (on any side) are not met the contract can be dissolved and the company can employ another CEO or the CEO can easily find alternative employment. Therefore as a result the negotiation of the contract should allow for a maximization of the value of the company. In general this concept refers to third parties that may potentially influence the level and/or structure of the CEO's compensation rather than the conflict between the agent and the principal.

In reality, the contractual arrangement and CEO compensation as one of its main components result from the co-existence of internal and external factors (Figure 1). There is no consensus as to which groups of determinants—internal or external—dominate in determining CEO compensation (cf. Stathopoulos & Voulgaris, 2016; Riaz & Kirkbride, 2017). This depends on the industry, region and organizational relationships (e.g. the case of international subsidiaries). Therefore it can be concluded that although the principal–agent conflict is embedded into compensation structuring there is much more to be considered when agreeing upon contractual arrangements. Since especially the external determinants vary amongst countries one cannot expect a universal system of contractual provisions that would be applicable regardless of the location-specificity (cf. Evans, 2014). However, the Investor Responsibility Research Center (IRRC) outlined a set of 24 provisions that “appear beneficial to management, and which may or may not be harmful to shareholders” (Bebchuk, Cohen, & Ferrell, 2009, p. 783). Based on these provisions the so-called GIM-Index was

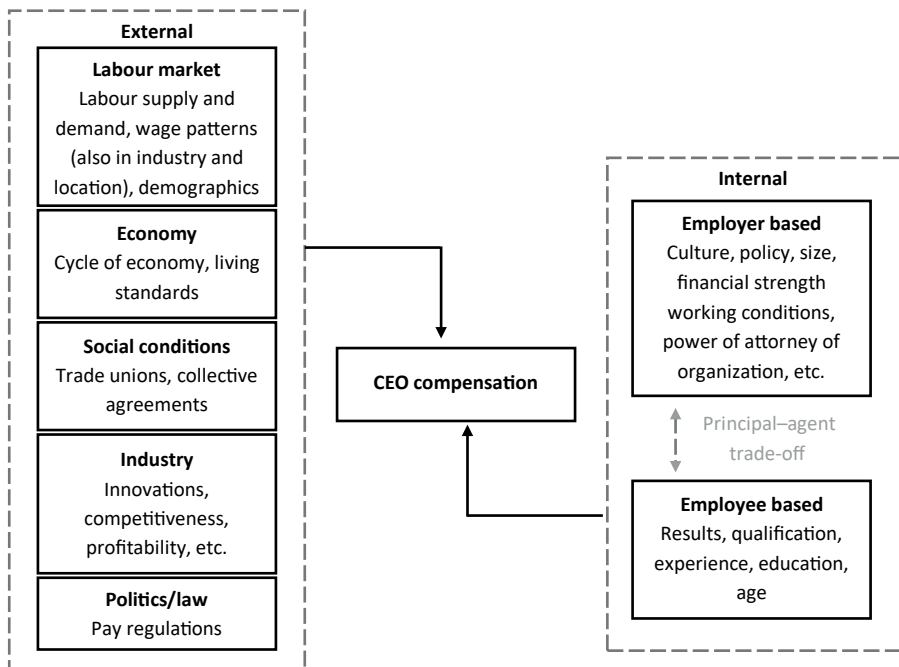


Figure 1. CEO compensation determinants

Source: Own elaboration based on (Silingiene, Stukaite, & Radvila, 2015).

established which is commonly applied as a measure of corporate governance quality. The provisions concern such issues as: delay, voting, protection, state and others (Gompers, Ishii, & Metrick, 2003, p. 111). According to Bebchuk and others (2009, p. 783) not all of the 24 provisions influence company performance (measured as Tobin's Q) in the same way. Bebchuk and others (2009, p. 39) suggest that only six of them bear a significant impact: four provisions that concern "constitutional limitations on shareholders' voting power" and the two provisions that refer to the "takeover readiness". These six provisions are referred to as the E-Index.

The discussion on executive compensation is always set against the background of agency conflict. Generally financial economists adopt the so-called "optimal contracting view" where the compensation policy is seen as a remedy for the said conflict. It recognizes that executives "suffer from an agency problem and do not automatically seek to maximize shareholder value" (Bebchuk & Fried, 2003, p. 73). Hence, remuneration policy should ensure the manager's cooperation in a cost-efficient manner. However, not only managers suffer from the agency problem. Board members—who in effect approve the executive pay suffer from it as well. Directors strive to get re-appointed for their positions as such role secures their financial and non-financial benefits, including prestige and social networking. Since CEOs are—more often than not—a part

of the nomination process, directors tend to favour the CEO while designing the compensation policy. It can be therefore concluded that CEOs have substantial managerial power to co-create their compensation packages which is much more favourable than contracts negotiated at arm's length (cf. Yoshikawa, Shim, Kim, & Tuschke, 2020). Bebchuk and Fried (2003, p. 75) claim that the phenomenon can be limited by the concept of "outrage", i.e. the reputational harm and embarrassment managers experience from relevant outsiders if the pay proposal seems inadequate. However, to avoid any unpleasantness both the executives and the Board of Directors apply "camouflage", i.e. tools to cover the rent extraction—in effect blurring the CEO's compensation disclosure. Here in the managerial power approach executive compensation is not a solution to the agency problem but it actually constitutes part of it.

2. Israeli corporate governance—main regulations

The Israeli corporate governance system is historically based on the British companies' ordinance published in 1929 (Lurie & Frenkel, 2003). The company ownership structure varied from the private companies owned by either families or united under *Histadrut* trade unions to state-owned companies and business groups. With time, namely in 1990, Israel established its own corporate governance regulations which were however still based on the British Mandate. The legislation has been frequently amended over the years. Probably the most known and at the same time most important change was brought about by the work of the Goshen Committee (Lifschutz & Jacobi, 2010). The committee proposed a draft of the CG code which followed OECD and the U.S. Sarbanes Oxley rules (Lifschutz & Jacobi, 2010). In consequence the Israeli corporate governance's main features are (Figure 2):

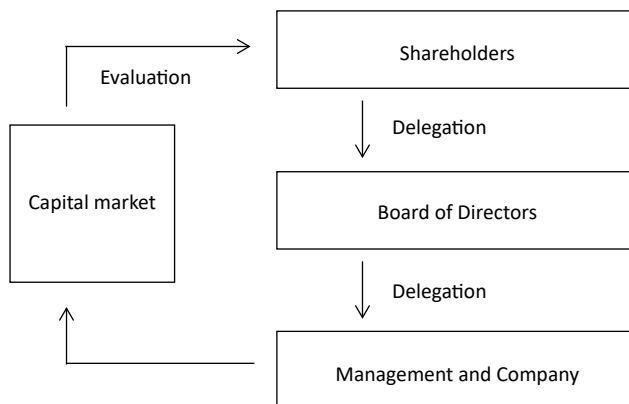


Figure 2. The Anglo-Saxon corporate governance system

Source: (Choi, 2011, p. 168).

- a one layer system,
- a minimum number of four directors on a board of directors,
- a ban on combining positions (CEO and the chairman of the Board of Directors),
- no obligation to have an employee representation on the board of directors,
- an audit committee which is responsible for board and executive remuneration.

The Israel Securities Authority approved in 2007 the Goshen Committee's recommendations and obliged all companies listed on the TASA (Tel-Aviv stock exchange) to implement the new regulations (Devash, Harel, & Rosen, 2006; Lauterbach & Shahmoon, 2010). In particular the recommendations concerned the problems of the structure of boards of directors and their independence, audit rules and procedures, transactions with related parties and finally the need to establish a specialized corporate and securities law court. The committee maintained that the board of directors' independence was one of the most important corporate governance issues in Israel (cf. Castellanos & George, 2020). Thus, its final recommendation was that every public company should have external directors who would constitute one third of all directors and their number should not fall below two (Goshen, 2006; Lauterbach & Shahmoon, 2010; Lifschutz & Jacobi, 2010; OECD, 2014, p. 33). The committee also recommended strengthening the internal audit committee in public companies. That is why the committee suggested that most of the audit committee members should be independent directors. The committee chairman should also be an external director (Goshen, 2006; Lauterbach & Shahmoon, 2010; Lifschutz & Jacobi, 2010; OECD, 2014, p. 33).

The Goshen Committee also addressed the difficult issue of transactions with related parties. This stems from the fact that most public companies in Israel are controlled by main, dominant shareholders. The concentration of ownership and, in fact, power might lead to biased deals and conflicts of interest. The committee found that in order to overcome the possible bias transactions with related parties should be studied and approved by a majority of the non-related parties and after 2010 by an independent law court. The new court was charged with preventing the exploitation of minority shareholders and discrimination by major shareholders. This new institution improved the quality in public companies' management, ensured the development of the Israeli capital market and in consequence secured better performance of the national economy (Goshen, 2006; Lauterbach & Shahmoon, 2010; Lifschutz & Jacobi, 2010; OECD, 2014, p. 33). Thanks to the new regulations the OECD corporate governance council entered into membership negotiations with Israel. These resulted in Israel joining the OECD in 2010.

In March 2011 the Israeli parliament approved the sixteenth company law amendment which was most important and meaningful for proper corporate governance. The amendment deals with the balance of power between the con-

trolling shareholders and the minority shareholders. In December 2012 Israel adopted the twentieth company law amendment which is of vital importance from the perspective of the CEO compensation establishment. The amendment forced public companies to introduce remuneration committees which are responsible for validating the CEO's compensation packages. Both the sixteenth and twentieth amendments to the 1999 Israeli company law force the top executives to work transparently. The transparency will allow all stakeholders to monitor the CEO's actions and to suggest a fair remuneration.

3. CEO compensation trends

CEO compensation generally comprises of different elements: fixed component (salary), bonuses (private healthcare, insurance, use of cars for private purposes, etc.) and deferred payment (stock options, SAR, etc.). As mentioned before, the USA has led the global trend in CEO compensation level for the last decade. However, it is closely followed by European countries and Canada. In recent years the structure of payment in different countries has been mostly stable. The Canadian and US incentives for their CEOs are mostly based on an equity premium whilst European countries tend to turn more towards fixed components and bonuses. In the long term it is however difficult to conduct cross-country comparisons due to differences in accounting and disclosure practices and the fact that some crucial information is unavailable to the public. Therefore, since the Israeli model is based on the Anglo-Saxon model which prevails in the USA the remainder of the section will be devoted to compensation development in the USA.

The Equilar⁴ annual CEO pay study of 2019 indicated that the median total CEO compensation totalled \$12 million which means a 7.2% increase from the previous year. This proves a slight but steady upward trend since in 2018 and 2017 and the studies also reported an increase of over 8% in comparison to previous years. Although the median compensation amounts to \$12 million the highest remuneration level reaches over \$129 million (Zaslav—Discovery). Among the 340 studied CEOs only nineteen were women. They earned a median \$13.4 million compared to \$11.7 million for male CEOs (Batish & Pontrelli, 2019). In relative terms the ratio of CEO compensation to average worker pay varies significantly depending on the industry and company size. The highest ratio was reported in consumer cyclical (162) and consumer defensive (130) companies whilst the lowest concerned financial services (39) and healthcare (48). The ratio increased with the company size (defined as revenue) where

⁴ Equilar conducts annual CEO compensation studies in association with Associated Press. The survey is made on the sample of S&P 500 companies.

companies exceeding \$10 billion revenue awarded their CEOs more than 213 times better than a median worker.

CEO compensation is driven by incentive-based pay which relates to company performance. An average CEO compensation package comprises of a 13% fixed in-cash payment, a 23% bonus, 49% of stock, 12% options and 3% of other company-specific regulations. Equity awards are expected to focus CEOs' attention on long-term performance since the vesting (i.e. exercise) time is usually several years to ensure a CEO's commitment in raising the stock price. The incentive-based compensation and especially equity-based packages are expected to solve the principal-agent conflict (agency theory) as they are based on company performance and tie in CEOs to the long-term company value.

Israeli CEO compensation trends⁵

Although the global trends show a gradual rise in CEO compensation level the situation in Israel is quite different. In 2009 the CEOs' total compensation for all 53 companies listed on TASE industrial index amounted to \$67.5 million. 2011 saw a rise to \$76.5 million. However, the subsequent corporate law amendments caused a rapid and substantial decline in the CEO compensation level. In 2013 the total compensation for the same company sample amounted to only \$36.5 million. The decline continued and in 2015 was below \$30 million whilst 2017 saw a small rebound to the level of \$34 million. All in all, the Goshen Committee recommendations caused compensation to even out (Figure 3). Although the average compensation level has not changed drastically the standard deviation decreased significantly which means that the pay gaps between companies started closing and became more even.⁶ 2018 saw a small decrease in the CEOs' compensation level in public companies (5%) which is attributed to the law limiting salaries in the financial sector enacted in October 2016.

The structure of CEO compensation in Israel is different compared to other countries of the Anglo-Saxon governance model (Figure 4). In the US and the UK compensation is mostly driven by equity-based incentives whilst in Israel the base salary prevails (53%-64%). The second major component are bonuses (22%-31%). Share based payment was mostly used in 2013 (12%) however it is now less frequently used and matches more less the level of social benefits (ca. 6%).

If one considers a wider sample that includes non-industrial companies (Gershgorn, Tefer, & Sabach, 2015) the conclusions are still similar:

- In the 100 TASA index—the changeable components (bonuses and equity-based) rate is between 41%-44%. The changeable components are divided almost equally between shares and bonuses.

⁵ The following section will be based on the TASE stock exchange industrial index.

⁶ In 2011 in the most extreme case, the CEO earned almost \$42 million.

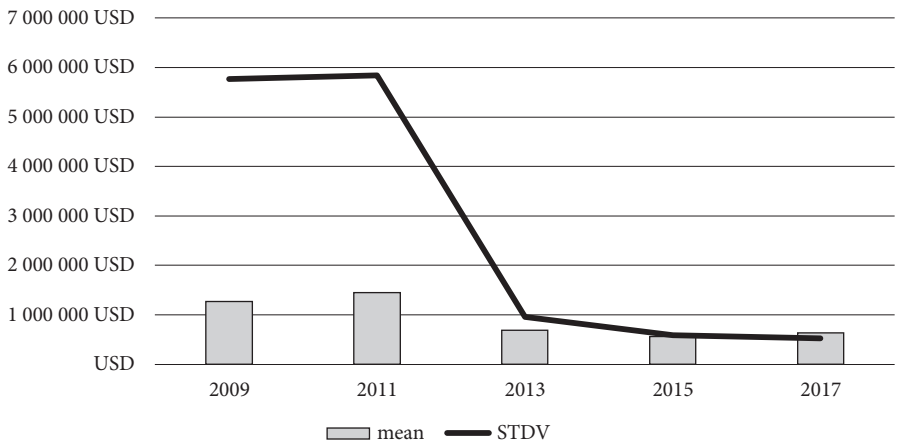


Figure 3. Average and STDV compensation for CEOs in US\$ 2009–2017
Source: Own elaboration.

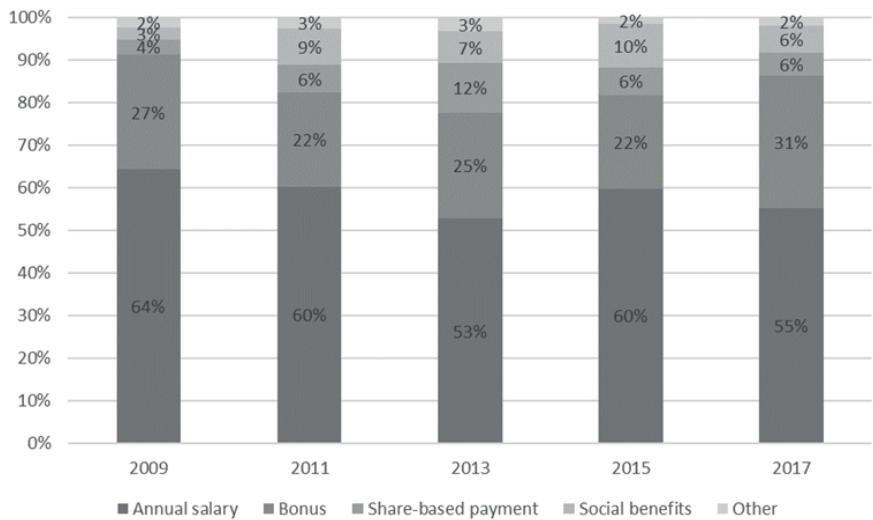


Figure 4. Structure of the CEO compensation 2009–2017
Source: Own elaboration.

- In public companies that are not in the 100 TSA index—the changeable components rate is between 22%–25%.
 - In bond companies the changeable components rate is between 27%–30%.
- Therefore, it can be concluded that the Israeli CEO compensation structure relates more to European standards than to the typical Anglo-Saxon economic pattern.

4. Can regulating the CEO compensation backfire?

The CEO compensation issue has been widely featured in public debate in the past three decades. It is increasingly discussed when it comes to public companies—firstly, since CEO compensation data is disclosed and secondly, since public savings (in the form of pension funds, mutual funds or insurance plans) are invested in such companies. Therefore, despite heavy criticism the Israeli government restricted the CEO compensation by means of legislation. The opponents claimed that such solutions would create complex, alternative compensation tracks that would evade the legislation. In 2016 the “law for senior management” limiting the compensation (the insurance, investment, and banking industries) was enforced. The law states that (Avriel, 2018):

- remuneration for senior executives exceeding 2.5 million NIS per year requires a series of approvals in the corporation’s institutions. In any case remuneration that is above 35 times the pay for the employee with the lowest pay in the company should not be approved,
- in the case where the company will decide to suggest a remuneration of above 2.5 million NIS to the executive, the part of remuneration that is above 2.5 million NIS per year will not be considered as a recognized expense to the employer.

Apart from the level limitation in public companies the compensation in Israel is determined by the existence of the Remuneration Committee, the inability to combine the role of the CEO and the Chief of the board of directors and some other limitations. Therefore, it is not purely up to market forces to determine how much the CEO should be paid but up to institutional regulations as well. Pay restrictions were also imposed in China towards centrally-administered state-owned enterprises whilst in the US changes are made mostly through taxation. The question remains whether such solutions are effective in decreasing the inequality gap and boosting the firm’s performance.

So far the evidence on regulating the compensation level and structure are mixed. On the one hand there is specific justification for increased governmental involvement in setting the pay (Marisetty and Venugopal, 2014; Thanassoulis, 2012):

- the externalities effect: companies with poor corporate governance and a high executive compensation level determine other companies’ compensation systems; CEO labour market is limited, therefore pay patterns spread market-wide and set expectations beyond a single company,
- default risk: the competition for executives (in a competitive market) generates negative externalities that increases a default risk of functioning; a regulatory cap may mitigate the risk while preserving the allocative efficiency.

On the other hand there is also evidence to the contrary (Abudy, Amiram, Rozenbaum, & Shust, 2019; Bae, Gong, & Tong, 2020):

- the high turnover of the top executives: evidence from the Israeli banking sector show numerous examples of CEOs with long company experience who switched either to other industries or to company foreign subsidiaries which according to the regulation were unaffected by the pay cap,
- appropriating company resources: evidence from China indicates that CEOs who suffer pay restriction receive more perks and channel company resources to an excessive extent, in effect hindering company value.

Conclusions

There is a common consensus that the average CEO compensation is too high compared to what median workers earn. Many claim that the executive pay should be dependent on the company performance to motivate the CEO to act in company's best interests. It remains however a puzzle as what is more effective in terms of maintaining company value—imposing governmental restrictions on pay levels or creating in-house, individual pay regulations. More and more countries turn to the so-called “say-on-pay” vote which means that the general meeting should approve the executive pay. The vote is non-binding however it gives social approval (or not) on the CEO's pay level. Another solution is introducing the *bonus-malus* system which means that executives suffer consequences of their unwise business decisions. This should limit the CEOs eagerness to take high-risk decisions. The possible strategies are numerous however no precise consensus on their effectiveness has been established.

The case of Israeli regulations is quite unique. Although the Israeli system is quite young and is based on Anglo-Saxon solutions it became relatively regulated in recent years. Certain restrictions have been imposed in the financial sector which until 2016 reported extraordinary CEO compensation levels. As a general rule remuneration committees and restrictions towards the duality of CEOs' roles were also introduced in public companies. Although there is little precise information on how it impacts the company's long-term value, it certainly shows that companies indexed on the TASA stock exchange report less inequality in industrial company CEOs' compensation levels. It can therefore be concluded that the regulations introduced more transparency into company pay systems.

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