Emerging trends in executive compensation: compensation benchmarking.

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Compensation benchmarking is the phenomenon of benchmarking a firm's executive pay to that of the peer firms. In recent times, the practice of compensation benchmarking has gained a lot of traction. As a result, researchers are increasingly addressing the dynamics of compensation benchmarking among the firms.

There are two competing potential theories to explain compensation benchmarking. Holmstrom et al. [1] suggested that compensation benchmarking is a feature of an efficient executive labor market. The executive compensation is determined by the supply and demand and hence benchmarked compensation is just the reflection of the market price. However, Bebchuk et al. [2] suggest that there is a potential problem at play. The executives are entrenched and powerful to influence the selection of the peer firms leading to selection of only those peer firms who offer best pay packages. So the benchmarked compensation is not a reflection of the market price, but is a result of the entrenched manager's powers to inflate their own salary. Differentiating between these two competing theories and determining the proper nature of the dynamics of compensation benchmarking is an interesting, yet relatively unresolved puzzle.

Security and Exchange Commission (SEC) adopted new proxy statement disclosure rule on December 15th, 2006. This rule compels the firms to report the executive compensation of the peer group of firms which were used to set the compensation of the executives of the firms. After the adaption of the rule, a growing number of empirical researches are examining the role of peer firms compensation in determining the compensation of the firms. Faulkender et al. [3] and Bizjak et al. [2] report that compensation benchmarking is an important driver of compensation. More specifically, both the papers report that the firms opportunistically select only the high paying firms while benchmarking the executive compensation thereby inflating the executive compensations.

In a follow up paper, Faulkender et al. [4,5] report that propensity pay gap, which is the difference in pay between the actual chosen peer firm and propensity score matched non peer firm, increased from 2006 till 2009. This increase in propensity pay gap is more prominent for those firms which suffer from weaker corporate governance. They infer from these results that the managers opportunistically choose the peer firms which offer higher pay packages thereby indirectly choosing their own compensation. The firms with weaker governance witness this problem even more.

There is an emerging literature which argues that the peer benchmarked compensation is a reflection of the market price of managerial compensation caused by the demand and supply. For example, Holmstrom and Kaplan [6] argue that propensity pay gap is highly dependent on the manner in which the non-peer firms are chosen; more specifically how the propensity score match is measured. They created their own group of non-peer firms for each of the peer firms. Interestingly, they report that propensity pay gap is almost zero. Schneider [7] demonstrates that small firms use peer benchmarking to adjust managerial compensation upwards in order to avoid managerial attrition.

What drives peer benchmarking in managerial compensation is still an unresolved but important question in the executive compensation literature. Several questions remain unaddressed. For example, what are the short term and long-term effect of compensation benchmarking on firm performance? How CEO turnover affect peer benchmarking? Do the firms always maintain the same set of firms as peers over a period of time or do they change the peer firms? Peer benchmarking has been reported only for US. What about peer benchmarking in other countries, especially in countries with weaker corporate governance? The readers can ponder over the various directions in which research in compensation peer benchmarking can progress.

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