Do executive compensation contracts maximize firm value? Evidence from a quasi-natural experiment

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Abstract: There is considerable debate on whether executive compensation contracts are a designed to maximize firm value or a result of rent extraction. The endogenous nature of executive pay contracts limits the ability of prior research to answer this question. In this study, we utilize the events surrounding a surprising and quick enactment of a new law that restricts executive pay to a binding upper limit in the insurance and banking industries. This quasi-natural experiment enables clear identification. If compensation contracts are value maximizing any outside, restriction to the contract will diminish its optimality and hence should reduce firm value. In contrast to the predictions of the value maximization view of compensation contracts, we find a significant positive abnormal return in these industries in multiple short-term event windows around the passing of the law. We find that the effect is concentrated only for firms in which the restriction is binding. We find similar results when we restrict our sample to firms with executive payouts that are just below and just above the pay limit.