The Economist on executive pay

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Evolution of executive pay in the US

A wall of money
Executive pay* relative to average wages in the US

*Includes salary, bonuses, long-term bonus payments and stock-option grants
Based on the three highest-paid officers in the 50 largest firms of the S&P 500 in 1940, 1960 and 1990
†Estimates
Source: Carola Frydman (MIT) and Raven Saks (Federal Reserve)
Executive pay in the world

[Diagram showing executive pay by country, with the United States leading significantly higher than other countries like France, Britain, Germany, and others.]

Source: Towers Perrin
Evolution of executive pay

- Recent years have seen a dramatic increase in executive pay relative to the average pay of all employees.
- This trend began in the US, but other countries are following along the same pattern (albeit not so markedly).
- There is a general trend of widening gaps between managers’ and workers’ pay, and greater emphasis on long-term incentives.
- There is a general feeling by many (including investors) that this pay is excessive.
Why the increase?

- In The Economist’s article, they begin by asking what are the economic and corporate shifts that have been the main causes of the rise in top managers’ earnings.
- Undoubtedly on the of reasons for the sizeable earnings of managers are the increasing importance of share options in their pay.
- According to The Economist “the chief mistake of the past 15 years was the granting of too many share options to too many people on terms that were too generous.”
Executive pay and shareholders’ value

- One of the reasons for the increase was also the fact that the granting of share options coincided with a period of soaring share prices (“bull market”).
- There have also been many illegal practices, as the Enron scandal in the past, or the recent scandal of backdated options indicate.
- But the author of The Economist’s article shares the opinion of Holmstrom and Kaplan that the rise in executive pay is deserved, because it was accompanied by a corresponding rise in shareholders’ value.
Grasso and the NYSE

- Richard Grasso was head of the New York Stock Exchange (a not–for–profit organization) starting from 1995.
- In 2003 he was offered a new contract with a huge increase in his pay, including a lump sum of $139.5 million.
- A later report found many irregularities: Grasso helped select the members of the board and the compensating committee; the committee’s members decided his pay without knowing his true compensation, because they did not know his (generous) pension scheme.
- Actually, many of those irregularities are typical in most large companies.
As head of RJR Nabisco in the 1980s, Ross Johnson used the corporate jet for his pet dog, listed as “G. Shepherd” on the passenger list. He employed maids on the company account and put sports stars on the payroll.

Kohlberg Kravis Roberts (KKR) became the paradigm of the so–called corporate raiders after their hostile takeover of RJR Nabisco, for which they paid $12 billion more than its stockmarket value of $13 billion.
Corporate raiders and managers

Whereas executives in public companies earned about $3 for each extra $1,000 of profits, managers in the buy out firms earned $64, according to Stephen Kaplan.

The raiders’ way to control management was later imitated:

- By loading the company with debt that needed servicing, the buy–out firms in effect took the decision about what to do with free cashflow away from managers.
- By taking the company private, they returned control of the board to the owners.
- By motivating and closely monitoring managers, they got them to take (sometimes tough) decisions that benefited those owners.
Options pay by sectors and internationally

**Options for all**
Average grant-date value of employee share options in S&P 500 firms £/02 dollars, $/m

- Employees below top 5
- Chief executive
- Other top 5

1992 93 94 95 96 97 98 99 2000 01 02

% of outstanding shares granted in options
By sector*
- New economy†
- Financial services
- Old economy†
- Utilities

1995 2000

*Firms in the S&P 1,500
†Tertiary industry and computer-related products
‡Primary and secondary industries
Source: Brian Hall (Harvard University) and Kevin Murphy (University of Southern California)

**Wages of the world**
Equity-based long-term incentives as % of total pay, by region

- United States
- Commonwealth
- Asia
- Latin America
- Europe

Sources: Brian Hall (Harvard Business School); Towers Perrin
Share options

- The widespread use of share options as an instrument to motivate managers to maximize shareholder value began around that time.
- At its peak in 2000 the number reached $119 billion, though by 2002 it had fallen back to $71 billion (all in 2002 dollars).
Changes in executives’ job conditions

- As a result of the new mentality, the job conditions of executives experienced significant changes.

- Between 1992 and 1997, chief executives could expect to last about eight years in the job. Between 1998 and 2005 that fell to six years, and executives from underperforming firms were more likely to have been booted by boards.

- At a survey about the replacement of 163 chief executives between 2002 and 2005, it turned out that in a quarter of the cases the executive had been forced out by the board.

- A related tendency is that of increasingly searching outside the company for a replacement of the chief executive. This happens nowadays in about one third of the cases, compared with only 10% in the 1970s.
New attitudes

- In addition, businesses seem to be placing a higher value on general management skills and relatively less on managers’ specific knowledge of their own company.

- A survey found that nowadays executive tend to have worked in more firms, have a broader experience within each company and have joined the firm they lead later in their careers.

- Some say the job has become more “Darwinian”. Their chances of losing the job have increased, and in turn they have become more selfish and less loyal to their companies.
Effects on executive pay

- Those changed conditions influence executive pay. Managers will need compensating for taking on the increased risk of losing their job and the shorter tenure that goes with it.

- The same applies for the risk of taking on options, which are less valuable than cash because they are illiquid and not certain to pay out.

- Pay will also tend to be inflated by the growth in an outside market for executive talent. The more the companies bidding for an executive’s talent, the more he or she can demand.

- These changes were magnified by the bull market and in turn probably helped to feed it.
The bull market did more than just increase share values: it also created a source of new demand for executives.

At the same time another more general force was pushing up executive pay. As the average firm size increases, so each company must pay its top executives more.

Between 1980 and 2003, a study has calculated that the size of American firms increased by a factor of six, more or less the same factor in the increase of top executives’ pay.
Pay and performance

Out of line
Pay and total shareholder returns

CEO total direct compensation*, $m

S&P 500 total return, %

*Median for 350 of the largest US public companies

Sources: Mercer; Thomson Datastream
The changes in executive pay are mainly motivated by the intention to tie it to performance.

When share prices (and dividends) came down between 1999 and 2003, executive pay not only maintained its level, but it actually increased slightly.

However, a study by Kaplan and Rauth in which they group companies with similar-sized assets, seems to indicate that there is a clear positive relationship between pay and performance.

In another study about the ex post value of options, it was shown that managers of the best performing companies end up by earning three times as much as managers of the worst performing ones.
Lucky rewards

- A study showed that, in the oil industry, the chief executives’ pay always benefits when the oil price is high, but does not necessarily suffer correspondingly when the price is low.
- In other words, top executives are rewarded for environmental circumstances that have nothing to do with their actions.
- In a large sample of firms, the study looked at the effect of changes over which managers have no control (eg, shifts in exchange rates): they found that the typical firm rewards its chief executive as much for luck as it does for good performance.
- Moreover, this effect cannot be explained simply by the increase in the value of managers’ share options: it also shows up in their base salaries and bonuses, which are directly controlled by boards. However, the rewards for luck were smaller in companies that were judged to be well governed.
Hiring of top executives

- In this case, information flows poorly, because buyer and seller are at high risk from leaks.
  - The executive does not want to let his employer know that he has been talking to another company—probably a competitor—until the deal is done.
  - The hiring company does not want the identities of its favoured candidates to be known because it might end up hiring someone who is obviously the second or third choice.

- About three quarters of chief executives appointed from outside between 1985 and 2000 were already chief executives or presidents elsewhere. This means that the effective supply is relatively narrow.
Hiring of top executives

- So most new executives hired outside swap a secure future for a risky one at the new company. That’s why they bargain to make their bonuses and options more secure.

- Usual safety devices include guaranteed bonuses, severance pay, hugely generous provisions if the company changes hands, perks, accelerated vesting of options and massive pension contributions.

- All of these measures limit severely the capacity of the firm to provide an incentive policy once they have hired the CEO.
Boards, directors, and executives

- Boards are agents too, and it is argued that their interests are more aligned with those of powerful executives than with those of the owners they are supposed to represent.

- The director’s role is ambiguous, because he is charged with counselling the chief executive as well as monitoring management’s performance.

- The duty to offer friendly advice inevitably interferes with the duty to admonish and if necessary to sack.

- The conflict has intensified as boards have been loaded up with responsibilities.
Boards, directors, and executives

- It is also argued that the chief executive can co-opt the directors in all sorts of ways.
- Although executives no longer decide who is nominated to become, or remain, a director, they still have a large influence over the pay and composition of the board.
- In addition, many directors were once chief executives themselves and are likely to think that others in that job deserve to be well paid.
- A study shows that weak boards pay chief executives more: high pay is associated with large boards, companies that have no outside large shareholder to monitor them, and companies protected by anti-takeover provisions.
Incentive effects of options

- Options may also have distortive incentive effects.
- In an overvalued stock market, options can make managers more short–termist than ever.
- If a manager knows his company is overvalued, he may use his inside knowledge to buoy up the share price in the short run.
- He can make acquisitions, delay investments, or manage earnings using questionable accounting in the hope that some unexpected good news will turn up, or that he will win enough time to make money from his options.
- In one survey, well over half of the chief financial officers being questioned said that they would cut a value–creating investment rather than miss an earnings target set by the market.
- And, as the Enron case shows, downright manipulation and fraud is also possible.
Backdated options

- Last year, William McGuire, CEO of UnitedHealth Group, together with his second in command, had to pay back about $390 million because the money was made from backdated options awards.
- That is, the timing of their options had been illegally manipulated to take advantage of a rise in the share price.
- It was one of many examples of a practice that spread surreptitiously across America, though it was curbed after a new legislation required an options grant to be registered within two days.
Backdated options

- An outside report commissioned by the company found that on 16 dates between January 1994 and August 2002 options were granted to the executives and other employees at one of the lowest share prices on that quarter.

- That would be extremely unlikely to happen by chance.

- William Spears, chairman of the compensation committee, had been a trustee for Dr McGuire’s children and had managed some of his family’s investments.

- In addition, Dr McGuire had backed Mr Spears’ money-management firm.
Private equity

- An indirect proof that there are better ways to do things is the rise in private-equity firms.
- Whereas 20 years ago a handful of private-equity firms (including KKR) managed $1 billion in assets between them, today 2,700 firms manage $500 billion.
- The boards of companies owned by private-equity groups are staffed by knowledgeable and highly motivated directors from the fund who have a lot at stake.
- Managers and directors are all working towards the same medium-term goal of listing or selling a company that will fetch a good price because it is seen to have a long-term future.
Private equity

- The arrangement is relatively free of ambiguities about purpose, and there is less temptation either to chase short-term results or to use the very long term as a sentimental excuse for indulgence.
- Central to all this is private equity’s way of attracting first-rate executives and then motivating and monitoring them.
- Pay in private equity can rival or exceed pay in even the largest listed company, but it is also more geared toward success or failure.
- But to earn high sums, private-equity managers have to bear far more risk than their counterparts in public companies do: the rewards for success are greater than in public companies, but so too are the consequences of failure.
Private equity: Sentinel Capital Partners

- Each group has its own formula, but at Sentinel Capital Partners in NY, as at almost all such groups, the partners require their managers to put in their own money as a token of their commitment.
- Up to 15% of a company’s equity is available for the top managers. They get paid a third of that if they last at the company until the fund sells out; another third if the fund earns three times its investment; and the remaining third when it earns five times its investment.
- In addition, Sentinel’s managers earn a basic salary and a bonus structured to reward profit growth and balance-sheet management.
Private equity: monitoring

- Private equity not only pays its executives more, it also monitors them more carefully.

- The boards of the companies it invests in are small, with around six directors, compared with 12 or 13 for a typical listed company in America.

- Directors bring business expertise and are highly motivated because their careers, as well as their own bonuses, depend upon their investments doing well.

- Contrasting with public firms, directors are intensely involved with the management of the company, and board meetings are generally far more constructive because of that.