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Is There A Problem With Executive Compensation?

Executive compensation has become a controversial issue in recent years. Cases of CEOs leaving office with large sums of money while the companies they led were in financial difficulties are regularly covered by the media and presented as proof that there is a problem. More recently, the economic crisis and government rescue of failing firms with public funds has justified imposing caps to executive pay. An internal managerial decision which traditionally was of relevance only to the administrators and shareholders of a given company is now being debated as a policy of interest to the general public. Is there a problem with the way executive compensation is determined?

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The agency problem

The debate centers on publicly traded companies, whose performance and compensation policies can sometimes be of interest to thousands and even millions of individual shareholders. These investors put their money in corporate equity with the goal of maximizing the value of their investment over time. They are the owners of the corporation and can have some say in the broad issues affecting it by voting for a board of directors and participating in its annual shareholders' meetings. But their influence derives mainly from their decision to buy or to sell shares. The day-to-day management of the company is provided by executive managers hired by the board to run it on behalf of its numerous owners.

It is one thing to realize that maximizing shareholder value must be the goal and another to identify the best means of reaching that goal. The main problem lies in the potential misalignment of incentives between shareholders and their executive agents, that is, the executives who run their firm. For example, executives could be tempted to make decisions that are in their own short-term interests but not in the long-term interest of shareholders.

To analyze this problem, a whole field of economic analysis, called "agency theory", has been developed over the past few decades.[1] The agency problem for shareholders is to align the incentives of their agents with their own goal, to tie their agents' remuneration to their performance in maximizing shareholder value.

Fixing the level of executive remuneration represents a relatively simple agency problem, because this remuneration is in large part determined on the market for executives. Through their boards of directors, shareholders of different companies compete for talented executives. Put this demand for executives in relation with the supply of executives – people who have the talents and the inclination to run firms on a daily basis – and you have a market which determines remuneration levels. A corporation cannot get a good executive if it does not pay the market price, and executives cannot get more than what colleagues with the same qualifications get. An indication of the fierce market compe-

1. By scholars like Adolf Berle (1895-1971), Gardiner Means (1896-1988), Eugen Fama (1939-) and Michael Jensen (1939-), among others.

titiveness is that some 40% of American CEOs are now hired from outside the company, a proportion that tripled over a few decades.[2]

There is much evidence that, consistent with shareholders' interest, executive pay is tied to performance. Economists have calculated that the six-fold increase of CEO pay between 1980 and 2003 is totally explained by the six-fold increase in market capitalization of large U.S. companies.[3] The median annual bonus of American executives fell by 19% in 2008, and that the fall was the most pronounced in industries that suffered the worst profit slumps.[4]

Variable, incentive-based remuneration rewards executives for their performance. A review of the largest 1,088 companies in the U.S. showed that executives in companies that performed better were better rewarded.[5] From 2005 to 2006, their profits on stock options increased 63% in companies with high returns and decreased 38% in those with low returns.

In Canada, a Hay Group annual study focusing on large cap Canadian corporations (S&P/TSX 60) has concluded that "[w]hile the correlation between pay and performance is relatively weak for the whole group, the results between the top/bottom 10 companies as well as the top 10 gainers/decliners tend to suggest that such a pay and performance relationship does exist."[6]

It is not surprising to find a close relation between executive pay and performance, for automatic mechanisms exist for shareholders to control their agents. Boards of directors, which are becoming more and more independent, are one such mechanism. And there are broader market processes at work. Activist hedge funds have much contributed to the reinforcement of boards of directors, and "raiders" are always on the lookout for companies that fail to deliver a good value to their shareholders.

How to optimize risk-taking

Another aspect of the problem is that what counts for shareholders is not only the level of executive compensation, but also – and perhaps mainly – what it is made of and what incentives are imbedded in its composition. We are back to the agency problem, where incentives are the name of the game. Does executive compensation, with its large proportion of the bonuses and long-term incentives (especially in the U.S.), lead executive to take more risk than the shareholders have bargained for? The short answer is no.

Being an executive is not a secure job. The CEO turnover rate has been increasing. In 2007, 57 of the S&P500 companies had a CEO change.[7] In 2006, one in three departing CEOs left involuntary. An executive has most of its eggs in a single basket: the corporation for which he works. His capacity to diversify his portfolio (of which his human capital is a big part) is limited. And he is expected to take risky decisions when they appear to be in the shareholders' interest. Who will take the hit if the results are not as expected?

Agency theory thus suggests that executives have an incentive to minimize the sort of firm-specific risks that shareholders eliminate through diversification of their portfolios. As a result, managers generally are more risk-averse than shareholders would prefer.[8] They would naturally tend to be too conservative in their strategic decisions. The main problem is not that executives take too much risk, as the vantage point of the current recession leads many to believe, but that they naturally want to keep their jobs and thus minimize their firm's risk exposure.

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2. Ira T. Kay and Steven Van Putten, "Executive Pay: Regulation vs. Market Competition," *Policy Analysis No. 619*, Cato Institute, September 10, 2008, p. 7.
3. Xavier Gabaix and Augustin Landier, "Why Has CEO Pay Increased So Much?," *Quarterly Journal of Economics*, Vol. 123, No. 1 (February 2008), pp. 49-100.
4. Data from Towers Perrin mentioned in "Restraints on executive pay: Attacking the corporate gravy train," *The Economist*, May 30, 2009.
5. Data from Watson Wyatt Worldwide mentioned in Ira T. Kay and Steven Van Putten, *op. cit.*, footnote 2, p. 3.
6. Kennedy Lee and Wiclif Ma, "Canadian CEO pay and performance," *Executive Briefing*, Hay Group, January 2009, p. 4.
7. Ira T. Kay and Steven Van Putten, *op. cit.*, footnote 2, p. 4.
8. Stephen M. Bainbridge, "Executive Compensation: Who Decides?," *Texas Law Review*, Vol. 83 (2005), pp. 1615-1662.

The shareholders will thus try to increase the executives' incentives to take calculated risks. The maximization of shareholder value requires a fine balancing of risk and security in executive compensation: the executive must be encouraged to take only as much risk as shareholders want to take, but to take such desired risks. If he is paid only a fixed salary, he will not pursue vigorously enough the goal of increasing profits over time. Similarly, if he does not get a good severance package, he will neglect strategies that entail some risk for him but are in the interest of shareholders. If, on the other hand, he receives only variable compensation (bonuses and long-term incentives), he is likely to take too much risk, because his downside loss is limited to his salary while his upside gains are as high as the stock market can go. The composition of executive remuneration between fixed salary and variable compensation is crucial to solving the agency problem.

The pitfalls of government intervention

Incentive-based remuneration of corporate banking executives dates back at least to the 19th century.[9] The phenomenon is thus not new. What has changed however in recent years – and is likely at the roots of the current controversy – is that government interventions in compensation policies and in the broader economy are distorting the traditional market-based ways to solve the agency problem. In this context, it is becoming increasingly difficult to judge if the increase in the proportion of variable remuneration over at least the past 15 years really reflects shareholders' wish that their agents assume more risk.

Theory and experience suggest that government cannot efficiently solve complex agency problems. Sometimes, it artificially favours variable remuneration, as it did with the 1993 amendment to the Internal Revenue Code that eliminated corporate tax deductions for non-performance-based executive pay over $1 million.[10] At other times, bowing to other sort of political pressures, it limits bonuses and encourages fixed remuneration, as we now observe. Such limitations on performance pay will mean less incentive for executives, and less flexibility for adjusting remuneration to changing circumstances in the future.

In fact, the U.S. government, which requires more executive pay disclosure than the governments of other countries, may well have contributed to executives obtaining higher compensation as they became aware of what their colleagues in other companies were earning.[11] It is also likely that detailed and strict governance legislation like the *Sarbanes-Oxley Act* of 2002 add a risk premium to executive remuneration.

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It could also be argued that government intervention played a role in making it possible for some CEOs to leave their jobs with hundreds of millions of dollars just before their companies went bust. Many economists have pointed out that the artificially low interest rates and the loose monetary policies engineered by central banks have created the dot-com and then the financial and real estate bubbles of the past fifteen years. It is obvious that those who exercised their stock options at the height of the bubbles, before the markets crashed, benefited the most from these reckless monetary policies.

Moreover, in the case of the financial industry, the market's self-correcting mechanism failed in large part because of a moral hazard problem. Investors assumed that the government would bail-out firms that were deemed too big to fail, which it actually did in most cases (Bear Stearns, Fannie Mae, Freddie Mac, AIG, Citigroup, etc.). Market discipline consequently broke down. This is more a government failure than a market failure.

9. See: Carsten Burhop, "Executive remuneration and firm performance: The case of large German banks, 1854-1910," *Business History*, Vol. 46 (2004), No. 4, pp. 525-543.
10. Jonathan R. Macey, "Washington's plans may result in even higher executive pay," *Wall Street Journal*, October 25, 2009.
11. *Id.*

One solution that is being put forward to give shareholders more control over the remuneration of executives is the "say on pay" rule. It allows shareholders to have a direct say through a vote which is either binding of simply advisory, instead of leaving matter entirely into the hands of the board of directors. In the U.S., Treasury Secretary Timothy Geithner has said that the Obama administration would like "say on pay" rules to be applied to all companies, not just those that have received bailout money from the government.[12]

Since the shareholders of a firm are its owners, it is entirely legitimate for them to decide to have a direct say on the compensation packages of their executives if they do so through the appropriate voting procedure. Whatever impact, negative or positive, such a rule may have on the performance of the firm will be revealed through competition and will be sanctioned by market participants. However, imposing it to all corporations through law will prevent us from knowing if it helps solve the agency problem or not. It may simply distort the market even more, as other government interventions did before.

Government interventions in compensation policies and in the broader economy are distorting the traditional market-based ways to solve the agency problem.

Conclusion

In 2005, according to U.S. Congress estimates, the median chief executive among 1,400 large companies earned $13.5 million in total annual compensation. Although this looks like a lot of money, it relates only to large companies. Another way to put this amount in perspective is to note that the average National Basketball Association (NBA) salary is almost $6 million a year, or that lead actors routinely earn $20 million for one film. But the latter rarely get criticized for this. The critics of the level of executive compensation often seem engaged more in a moral denunciation of capitalism than in a rational discourse about economic efficiency.

When, under pressure from those critics, governments try to replace supply and demand in setting remuneration by other arbitrary rules, they distort the most important mechanism by which firms can influence the choice of their executives and their overall governance structure. It is in the interests of shareholders to have efficient executive compensation. The best way for governments to allow shareholders to get the executives they want and pay them the optimal amounts is to stop interfering in the market process, not to add more interventions to those that already exist.

12. Phil Mintz and Jane Sasseen, "Geithner: 'Say on Pay,' No Caps," *BusinessWeek*, June 10, 2009.

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