Column : The bluff on bonus

The Financial Express
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March 25, 2009

There is something not quite right about hosting a party when a city burns. It is actually immoral when the party is sponsored by funds from the fire victims without their explicit consent. And, if the negligence and greed of the party throwers contributed to the fire in the first place, even if unwittingly or in the slightest measure, then it is downright criminal. So, the uproar and the unusual tax bill in the US Congress following the AIG bonus issue should be hardly surprising. The issue at stake is executive greed and propriety particularly when public funds are involved, not the doubtless centrality of AIG's role in the crisis, nor the sum of money involved, modest as it is by Wall Street standards.

The public furor has brought much needed public attention to the executive compensation racket that went out-of-control years before the crisis and stretches far beyond the financial sector. Harvard professors Lucian Bebchuk and Jesse Fried had already documented the phenomenon in their 2004 bestseller, Pay without Performance. In 1991 the average large-company CEO received 140 times the pay of an average worker; by 2003 the multiple jumped to 500. A few popular myths have aided them well in accomplishing this without much public outrage till of late.

Myth #1: Executive compensation is decided by a board representative of shareholder interests. Executive pay is neither market determined nor an outcome of a bargaining process between CEOs and boards loyal to shareholders. In reality, CEOs set their own pay by having pliant boards and compensation committees manned by friendly independent directors and have little hesitation in milking the companies they run. Directors, independent or otherwise, are too beholden to management to "rock the boat". Collegiality and reciprocity are the highest virtues in most boardrooms and management holds the key to reappointment.

Myth #2: Pay is linked to performance and serves as an incentive for better future performance. Hardly. Over time, stock grants and options notwithstanding, top executive pay stands increasingly divorced from performance.

Creative accounting is a way out. Back in 2000 and 2001 companies like GE and IBM included their pension returns to justify bonus amounts. When even its pension fund lost money, Verizon went a step further and simply revised its estimation of future returns on pension assets, to calculate bonuses.

Targets are always negotiable. Coca-Cola promised CEO Douglas Daft a bonus increase if the earnings rose by 15% annually over a 5-year period. It promptly revised that threshold to 11% after an earnings expectation cut. Most successfully concluded acquisitions win hefty bonuses for the acquirer's top executives. On average, acquiring shareholders lose money in transactions where the CEO gets a bonus for the deal.

Golden hellos—“hiring/signing bonuses”—running into several millions have no performance clauses and often have guaranteed minimum pay. Bob Nardelli of Home Depot had his full compensation plus close to $30 million in severance pay assured at sign-up.

Poor performance is seldom punished. Mattel CEO Jill Barad took home $50 million in severance pay for working for two years during which the stock price fell by half.

Myth #3: Top executives of major companies are people with extraordinary and irreplaceable talent that deserve their “rents”, much like film and sports stars. There is a major flaw in this argument. While sports stars and film stars may be making as much money as CEOs or even more, there is no doubt about the “arm’s length” bargaining in their case. No producer or team owner or advertiser will pay more than what he believes the superstar will contribute to his bottom line—the star does not control the purse. For CEOs, it is a deal in which he practically pays himself, Sarbanes-Oxley, compensation consultants and committees notwithstanding. There lies the difference. High pay for executives is therefore, not an indication of their value to the company but rather a reflection of their power.

Myth #4: The only way to get talent is to pay what everyone else is paying. Most companies that use peer standards in setting pay set their CEO pay above the 50% mark or higher. This leads to the “Lake Wobegon effect” where everybody is somehow “above average”. Net effect: the average keeps rising regardless of performance.

The malady is widespread and pre-existing. That does not mean Wall Street should not be brought to book. Their treatment of bonus as an entitlement in these troubled times has been truly shameless. AIG is hardly alone. Wall Street firms together doled out a hefty $18.4 billion in bonuses in 2008. There is already concern expressed that the proposed 90% tax will lead to the exodus of talent from the industry. That is typical Wall Street baloney. There is hardly a queue of hirers to affect the exodus and as for the talent part, the less the said the better. It is time to call Wall Street’s bluff.

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