Restraints on executive pay

Attacking the corporate gravy train

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The global downturn has sparked outrage over executive compensation. Only some of it is justified

EARLIER this month Iain Coucher did something rather unusual for a chief executive. Mr Coucher, the boss of Network Rail, which is responsible for Britain's railway infrastructure, announced that he did not want an annual bonus this year, even though he had pocketed one worth £306,000 ($614,000) in 2008. The reason for such selflessness? Mr Coucher said he was "mindful of current sentiment" and wanted to avoid an outcry that would overshadow his firm's achievements— although he is hanging on to a potentially lucrative long-term bonus plan. Britain's transport minister, Lord Adonis, heaped praise on Network Rail's boss for his "responsiveness to the public mood at this time of economic hardship".

That mood has turned very ugly indeed, and not just in Britain. In many countries popular resentment at Croesus-like pay packages for chief executives has prompted critical headlines and a loud chorus of complaint from politicians. Although bankers have been the targets of the sharpest barbs, plenty of bosses in other industries are also getting a tongue-lashing. When Valeo, a troubled French car-parts supplier, awarded a €3.2m ($4.4m) payment to its departing chief executive in March, France's prime minister, François Fillon, lambasted the decision. "The time has come to show responsibility," he thundered, "and those who do not show responsibility put our entire social and economic system at risk."

Politicians are not the only ones getting hot under the collar. So, too, are some big investors. On May 19th the directors of Royal Dutch Shell received a stinging rebuke when 59% of voting shareholders rejected a pay deal for the oil giant's senior executives. The vote was not binding, but it was highly embarrassing for Shell's board, which had decided to hand over shares as a bonus to managers even though the firm had missed performance targets.

Faced with public outrage over what they consider to be unbridled executive greed, many governments are preparing new rules to rein in pay. Most of these measures will be aimed at companies that have been rescued at taxpayers' expense. For instance, America's treasury secretary is due to unveil guidelines on pay for companies that have received aid under the government's Troubled Asset Relief Programme (TARP). But some plans have a broader sweep. The German government has put forward a draft law which is aimed at all publicly quoted companies and which includes provisions that would force executives to hold share options for at least four years, instead of two. The German proposal would also require all members of a board, rather than just a subcommittee, to sign off on matters of pay.

All this political interference in what companies decide to pay their executives raises two important questions. Is the process for setting bosses' pay broken? And if it is, what should be done about it?

From payday to mayday

There is now little doubt that pay was a contributory factor in the banking industry's meltdown. Accustomed to fat annual bonuses that were multiples of their base salaries, many bankers had little reason to dwell on the risks associated with the deals that they were signing. Even some of the industry's leading lights, such as Lloyd Blankfein, the head of Goldman Sachs, have publicly acknowledged that the incentives such schemes created helped send the industry plunging into an abyss.

Banks are rejigging their compensation plans in response to make base salaries a bigger percentage of overall compensation. On May 22nd Morgan Stanley's board approved a hefty increase in the base pay of several senior executives, including its two co-presidents, whose salaries are rising from around $300,000 to $800,000 a year. The firm also said it was raising the base salaries of several other categories of executive. Other banks are likely to follow its lead. They are also bringing in clawback systems that allow them to recover some or all of bonuses if the deals on which these were based subsequently turn sour.

One person at Morgan Stanley who did not get a rise in salary was its boss, John Mack, whose base pay will remain at $800,000 a year. Like many other chief executives, Mr Mack has a mountain of equity-related incentives that are supposed to ensure that he takes a long-term view of his company's fortunes. But in spite of such holdings, some chief executives, such as Dick Fuld at Lehman Brothers and Jimmy Cayne at Bear Stearns, let their firms take huge risks and then paid the price when the value of their shareholdings evaporated.

What went wrong? With hindsight, it is clear that the industry's leaders collectively failed to understand the nature of the risks their firms were taking on. But Lucian Bebchuk, a pay expert at Harvard Law School, sees another problem. He points out that equity-based bonus plans align bankers' interests only with those of shareholders. This encourages them to make big bets that could dramatically increase the value of a bank's shares. But if those bets go wrong, then it is not just shareholders who end up shouldering the catastrophic losses; they are borne by unsuspecting bondholders and taxpayers too. To solve this problem, Mr Bebchuk recommends linking bankers' fortunes not just to share prices, but also to, say, the price of credit-default swaps on a bank's bonds.

Although such a market-based approach is attractive, the American government seems bent on regulating banking pay more tightly. The good news is that it appears to have dumped the daft idea of imposing pay caps on banks, which would simply have driven talented people out of the industry. But there are still grounds for concern. The TARP rules seem to imply that executives of firms receiving money from the government will not be allowed to pocket any long-term incentives until their firm has paid it back. This could result in some banks seeking to quit the programme before they are fit enough to do so.

Strict limits on performance-related pay at banks could also do more harm than good. One reason American business has thrived for so long is that its leaders have had a stronger incentive to perform well than those of other countries (see chart 1). Limiting the ability of financial institutions to pay sensible bonuses will simply prolong their woes. Edward Liddy, who was

brought in to run American International Group (AIG) after the ailing insurer was rescued by the government, recently gave warning that executives cannot be expected to toil 24 hours a day without being adequately compensated for doing so. Mr Liddy, who plans to leave AIG once a successor has been found, cut his base salary to $1 a year in November 2008 following howls of protest over the pay of bosses at firms that had received bail-outs.

Corporate lapdogs

Some critics claim it is not just banking that has a pay headache. They argue that many bosses in other industries are overpaid because weak boards have allowed them to dictate the terms of their compensation. As a result, pay bears little relationship to performance and tends to rise inexorably. A chief critic of the supposed corporate gravy-train is Warren Buffett. At the annual meeting of his holding company, Berkshire Hathaway, on May 2nd the legendary investor railed against a system that lets chief executives choose the members of remuneration committees. This, he claimed, allows them to select compliant directors prepared to wave through pay proposals. “These people aren’t looking for Dobermans,” he complained. “They’re looking for cocker spaniels.”

Investor protests such as the one at Shell appear to support the thesis that boards are a soft touch. So does the proliferation of perks enjoyed by some bosses, especially American ones. One of the most controversial of these is the so-called golden coffin, under which the heirs of a chief executive can collect severance-style death benefits, such as unvested share options, if the boss suddenly dies. Shareholder activists in America have been trying to bury such coffins for good this year, but without much success.

A big problem, they say, is that too many institutional investors are willing to rubber-stamp pay plans. A recent study by the Corporate Library, a research firm, reviews the proxy-voting trends of 26 large American mutual funds on pay-related matters. Entitled “Compensation Accomplices: Mutual Funds and the Overpaid American CEO”, it shows that the average level of support for management proposals on pay rose from 75.8% in 2006 to 84% last year. Manifest, a European shareholder-advice firm, says 97% of all shareholder votes cast in Europe last year were supportive of management.

Activists claim such studies prove that shareholders are asleep at the till. But another explanation for the results is that the current system of setting bosses’ remuneration is in better shape than Mr Buffett and others believe, and that shareholders are, by and large, happy to support it. Although some outrageous pay deals do get waved through, there is evidence that the pay-for-performance model is functioning reasonably well and that boards have more clout than Mr Buffett seems to think.

Start with the link between compensation and profitability. If boards really are in the pockets of chief executives, then it seems unlikely that bosses would let them reduce their pay. Yet many European companies have been slashing senior executives’ compensation as their profits have plunged. In April, for instance, Bosch, a German engineering giant, said that remuneration for its top-ten senior managers fell from €18m in 2007 to €13m last year, and that their pay had been frozen for 2009. American bosses are also feeling the pinch. According to Towers Perrin, a

consultancy, data from American firms that had filed their 2008 proxy statements by the end of March show that, although median base-salaries rose slightly, the median annual bonus fell by 19%. Another sign of pay for performance being a reality is that bonuses fell the fastest in those industries which experienced the steepest fall in profits. In a separate study of 135 public companies' compensation reports, the consultancy concluded that over half were planning either to freeze or reduce salaries in 2009.

Long-term awards are also falling. Another consulting firm, Hewitt, looked at share options and other such rewards granted by big American companies to executives between December 2008 and April 1st 2009. It concluded that the median decline in their value compared with the set of grants made in the previous year was 20%. And it noted that the firms that had made the biggest cuts were those whose share prices had fallen the most.

There are other signs of the market at work. "Boards of directors are more responsible than people give them credit for," says Stephen Fackler of Gibson, Dunn & Crutcher, an American law firm. He points out that more companies are moving away from awarding share options and towards issuing performance-based restricted shares. These typically vest after a certain time only if a company has both increased value for its shareholders and performed well against a peer group.

All this suggests that even in America, the land of the superstar chief executive, boards are not bosses' poodles. In a paper entitled "Embattled CEOs" published in October 2008, Marcel Kahan of New York University's School of Law and Edward Rock of the University of Pennsylvania Law School argue that bosses have in fact been losing power steadily to boards of directors and shareholders over a number of years. One reason for this is the rise of activist hedge-funds, which target underperforming firms and lobby directors to improve their returns. Another is the growth of influential shareholder-advisory outfits, such as RiskMetrics and Glass Lewis, which scrutinise firms' activities, including pay plans, and make recommendations to clients on how to vote their shares.

Regulatory actions have also encouraged boards to get tougher on pay. For instance, Messrs Kahan and Rock note that new stockmarket regulations in 2006 forced companies to publish the various components of a chief executive's pay and to justify them. These and other changes may explain why Steven Kaplan, a professor at the University of Chicago's Booth School of Business, has found that median pay awards to bosses in America—comprising base salary, bonus, restricted shares and the expected value of share options—stayed roughly flat between 2000 and 2007, at around $8m a year. Bosses may ultimately have pocketed much more than that thanks to buoyant markets, but it appears that boards have not been deliberately inflating their potential earnings.

Although the pay system is not broken, parts of it are badly in need of repair. One example is severance payments that appear to reward executives for failure. Strange as it may seem, the principle behind these is sound: managed well, they give bosses an incentive to fess up to serious problems rather than trying to disguise them for as long as possible. That ultimately benefits shareholders. But some payouts are a lot more generous than they need to be. Boards should also

take a hard look at many perks, such as golden coffins, that crept into contracts in boom times, but have nothing to do with performance.

Some experts give warning that reform needs to happen fast if the pay-for-performance system is to be preserved. “There is a real danger that we will lose the freedom to use pay as a force for good,” says Sean O’Hare, a partner at PricewaterhouseCoopers. That risk might not yet have sunk in to every occupant of a corner office. Ira Kay, the head of the compensation practice at Watson Wyatt, a consulting firm, says that although many boards have embraced the need for change, some executives are still resisting because they think the fuss over pay will soon blow over.

Paid if you do, paid if you don’t

That may give governments an excuse to act. Australia, for instance, has floated plans to force firms to get shareholder approval for any severance packages bigger than a chief executive’s annual base salary. Yet politicians’ attempts to meddle with pay have often backfired. America provides a cautionary tale. In 1984 the government tried to cap severance payments at three times base pay by imposing a special tax on any payments above that level. But the multiple of salary quickly became a starting-point for new deals and companies agreed to cover the tax that bosses incurred on more generous arrangements. Then in 1993 a $1m cap was imposed on the tax deductibility of executive salaries. This had two unintended consequences: salaries underneath $1m quickly rose to that level and firms promptly showered their bosses with share options and other forms of pay that were not covered by the limit.

So what, if anything, should governments be doing now to address the issue of pay? The main thing is further strengthening the ability of shareholders to monitor and influence compensation deals before they are signed off. That way, cases of abuse can be dealt with swiftly. A step in the right direction was recently taken by America’s Securities & Exchange Commission, which has proposed a new rule that would make it easier for investors to nominate directors to corporate boards.

America should also make “say on pay” votes by shareholders mandatory at public companies. Although such votes are not binding, they do force boards to justify compensation policies regularly and can be a useful channel for expressing displeasure if something does not feel right, as Shell has just discovered. Common in Europe, the votes are not required in America at present, except at companies that have tapped the TARP. Nevertheless, investors there can lobby for votes to be held at any publicly quoted firm and the number of requests for say-on-pay ballots in America has been rising steadily (see chart 2).

Charles Schumer, a Democratic senator, has just introduced a bill in Congress that would, among other things, force all public companies to submit their pay policies to a vote. Some firms reckon this would be an annoying distraction. They also fret that special interests, such as public-sector pension funds, will abuse the system to further their political agendas. But the track record from Europe shows that what say-on-pay tends to do most of all is encourage a better dialogue between shareholders, managers and boards on pay-related matters ahead of votes.

Expect more examples of corporate greed to surface in the coming months. Although these will be exceptions rather than the rule, they will almost certainly increase populist pressure on governments to meddle in the market for top-level executive compensation. If politicians respond by issuing ill-conceived rules on pay that strangle the entrepreneurial spirit, the only thing that will end up getting derailed is a global economic recovery.