Business as usual on executive pay?

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Last autumn, amid the maelstrom of the financial crisis, it seemed that fundamental change was afoot. "A new capitalism will emerge from the rubble", declared the BBC's business editor, Robert Peston. And in the court of public opinion, driven to the point of fury by tales of huge bonuses in a failing banking sector, nowhere was this change more keenly sought than in the sphere of executive pay. Vince Cable, the Liberal Democrat Treasury spokesman, even suggested that failed but wealthy bankers should count themselves "lucky the British have no guillotines in stock".

Several months later, some evidence indicates that the widespread desire for a brake on executive pay might be beginning to be realised. In the UK, shareholders recently rejected Shell's executive remuneration plan, and have also registered significant "no" votes against pay deals at major companies such as Xstrata, BP and Amec.

"Clearly, most CEOs at large companies were not immune to the financial fallout from the economic crisis and stock market losses of the last year," says Ira Kay, global director of compensation consulting at Watson Wyatt and co-author of Myths and Realities of Executive Pay. "Pay packages will be realigned to reflect the new economic reality that is currently unfolding."

But are we experiencing a pivotal period in the history of executive pay, signalling the beginning of a sustained descent? Or is the current climate merely a blip in an otherwise relatively smooth upward trajectory?

Sceptics point to the last time executive pay fell by a significant margin. Between 2001 and 2002, after the dotcom bust, median compensation for US chief executives at companies in the Standard & Poor's 500 index fell by almost 10 per cent. However, from a base of about $7m in 2002, that figure stabilised and rose steadily and significantly over the following years.

"Executive pay is highly correlated with the stock market," explains Mr Kay. "To the extent that the stock market recovers, especially if it's through improved profitability, then pay will follow."

The profitability of the corporate sector might take some years to recover. But when it eventually does, will there really be a return to business as usual?

The main obstacle could be the sheer magnitude of public outrage in recent months, which has in turn triggered demands for tighter regulation of executive pay. Peter Montagnon, director of investment affairs at the Association of British Insurers, says we should be wary of the assumption that we will simply wind the clock back.

"People have seen from the banking collapse that the contribution being made [by bankers to the economy] was not necessarily what it was cracked up to be," he says. "The crisis has been so
profound that you can no longer be sure that what was acceptable yesterday will be acceptable tomorrow. Unless we restore credibility and integrity to the system, it will be much harder to reward success."

Corporate concern about public outrage may not only stem from its potential to erode shareholder support and from a desire to protect the company's reputation in the marketplace.

According to Lucian Bebchuk, director of the corporate governance programme at Harvard Law School and co-author of Pay without Performance: The Unfulfilled Promise of Executive Compensation, individual directors are also concerned about suffering damage to their own personal standing if they agree pay awards that subsequently attract criticism. For example, following the controversy over the pension awarded to Sir Fred Goodwin at Royal Bank of Scotland, Sir Tom McKillop, the former RBS chairman who helped to negotiate it, felt obliged to step down as non-executive director at BP.

However, while the weight of public opinion might be sufficient to persuade British politicians to execute far-reaching reform of their own expenses system, the extent to which it can act as a long-term constraint on executive pay is open to question. "Directors are protected as long as they stay within the norm," says Prof Bebchuk. "The fear of outside outrage provides little incentive to do better than standard practice." If and when that norm starts creeping up again, they might hope to hide behind the general trend.

Indeed, companies have in the past continually raised executive pay in spite of very negative popular attitudes, albeit not articulated with the same intensity as today. In a Financial Times/Harris poll in July 2007, before the credit crunch had started to bite, nearly 80 per cent of British, German and American respondents believed that senior executives were paid "too much", and 60 per cent in Britain thought the government should impose pay caps for heads of companies. This public disapproval has traditionally been viewed by boards and shareholders as secondary to the imperative of rewarding executives.

Moreover, people can only be angry about a pay award when they know about it. Public companies only have to disclose the board's remuneration. Much recent ire has been directed at the general pay culture within investment banking, often earned by "rainmakers" below the top level where individual awards are hidden from view.

Johnson Associates, the compensation consultancy, has predicted that, even this year, bonuses may rise by up to 30 per cent in certain sectors on Wall Street. In companies that obtained financial assistance from governments, there has been a move to increase salaries to offset the reduction in bonuses necessary to placate public opinion and the authorities. "The banks where governments intervened are having to change the way they traditionally compensate for performance," says Tim Sheffield, chief executive of Sheffield Haworth, the financial services recruitment firm, "whereas others are really just tweaking their compensation model."

Recent media attention has focused on the debate about potential tighter regulation, particularly in the financial sector. While regulators hone their recommendations, there have been calls in the UK for increased shareholder rights, including a requirement that shareholders subject members
of a company's remuneration committee to annual re-election and approve the appointment of remuneration consultants. In the US, Timothy Geithner, the Treasury secretary, recently suggested incentives should be better constructed in the financial sector to avoid short-term risk-taking.

Mr Kay believes it was "the demand for top talent that drove the increases in executive pay". Indeed, recent academic research has indicated that investors respond well to highly paid chief executives, believing that their high pay was in itself confirmation that "top talent" was leading the company (see box).

The past few months, however, have seen an upsurge in popular cynicism about the alleged rare ability and impact of business leaders. If that cynicism about the "superstar" executive is finding its way into the minds of institutional shareholders, the days of ever-increasing compensation may indeed be drawing to a close.

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In the fictional town of Lake Wobegon, a creation of American author Garrison Keillor, all the children are above average. In CEO pay and the Lake Wobegon Effect, a forthcoming paper for The Journal of Financial Economics, Scott Schaefer and Rachel Hayes argue that companies might raise the pay of their chief executives because they want investors to believe that the company had an above-average chief executive.

The academics from the University of Utah point out that higher pay is seen as proof of higher ability. "Everyone knows that in well-functioning labour markets, better performers earn higher salaries," Mr Schaefer says.

If a company pays the chief executive a comparatively low salary, analysts might conclude that he is not up the mark and will downgrade the stock.

If, on the other hand, the company boosts the salary significantly, investors might conclude that the chief executive is a superstar, and the share price might jump. If the increase in the stock price is greater than the increase in the chief executive's salary, this could be a wise move by the company.

If all companies believe they can attract and retain investors by paying their chief executive more than the market average, a constant upward pressure on chief executive pay is generated.

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