Running out of Options, Pay for Performance

The Economist
December 11, 2004

IT SEEMED like a good idea at the time. Align top executives' pay with the performance of their firms and all will be uplifted-shareholders' returns and managers' returns too. What's more, there seemed to be a simple tool to do this: share options. Award managers the right to buy shares at a certain price, then when their efforts pushed the price above that level they would make a profit, just like the shareholders.

That was in the late 1980s and early 1990s, and for a decade or so the idea seemed to hold good. The longest bull market in corporate history gave managers and investors alike huge rewards. But the years since the stockmarket crash in 2000 have made it clear that something was badly wrong with this system. The rising tide of the market had, as it were, lifted all boats; when that tide receded not all those boats fell to the earth with a thump. Indeed, some boats didn't fall at all. In each of the three years from 2000 to 2002, shareholders in America's S&P 500 companies lost between 9% and 22% of the value of their assets. Yet the average total remuneration, including option gains, of the CEOs of big American companies was higher in 2002 that it was in 1999 and 2000. What had happened to the idea of pay as a reward for performance?

The fundamental error was to put most of the burden on stock options. Share prices rise for a host of reasons that have little to do with the performance of the company's managers-especially in a raging bull market with half-crazed speculators searching irrationally for the next big gain. And when share prices move sharply on shifts in actual and projected corporate results, and managers control the timing and presentation of those results, the temptation to manipulate the figures to show them in the best possible light can prove irresistible.

Finally, there was little downside to the stock-options strategy. Managers were often allowed to reprice their options so that they never showed a loss, and typically they were able to sell them after a short vesting period, enabling them to reap passing short-term gains and removing much of the options' power to motivate longer-term performance. On top of this, shareholders were often unable to see that executives' total returns were still riding high when theirs were not because managers to some extent controlled the information that their companies disclosed about their (often very complicated) remuneration packages. By and large, corporate philosophy on disclosure was "the less than better".

Slowly the veil is being lifted from shareholders' eyes (see page 70). William Donaldson, the chairman of America's Securities and Exchange Commission (SEC), said last week that, "we have to strive to get that information [on executive pay] in understandable and complete form". Last month CalPERS, America's biggest pension fund, adopted a plan to "tackle abusive executive compensation" which includes submitting a proposal to the SEC next year for greater transparency of compensation

packages. Does this then mark defeat for proponents of the principle of pay-for-performance as more and more firms reveal the extent to which the truth has been "Pay without Performance"- the title of a recent book by two American law professors, Lucian Bebchuk and Jesse Fried?

Not necessarily, for the idea remains essentially sound. Even the highest-paid executive is still motivated by pay-if not for the sake of further filling his pocket then for the prestige it gives him among his peers. What is needed is further refinement of pay schemes that have relied too heavily on stock options. The urge to do this could be boosted next year if, as seems likely, American companies have to "expense" their options-ie, put a value on them in their accounts. That they have not had to do so until now has made options superficially "free" to the company issuing them, another dangerous aspect of their allure.

Stock options may still have a role to play if most of their windfall element can be eliminated, and executives' ability to offload them in the short-term is constrained. But other approaches too look promising. In Germany, companies are deeply wedded to the idea of annual cash bonuses. Tied to the right targets these can be effective. Three-quarters of Britain's FTSE 100 have schemes which give executives shares, but then allow them to sell these shares after a number of years, and only then if the firm meets minimum performance standards relative to its rivals. Such "restricted" stock should be able to focus managers' minds on the medium to long term.

Whatever scheme is adopted, the only way that shareholders can judge whether it is really working and executives are being rewarded only for a job well done is if pay and performance figures are disclosed, transparently and in full. Big investing institutions should demand more such disclosure. And if that does not work, regulators should require it.