HOW TO FIX EXECUTIVE PAY

(Good) CEOs Are Underpaid

The most fundamental answer to the question---are CEO's overpaid? ---is to compare pay to performance. In plain English: in her industry or sector, what did the CEO do personally to make a difference?. Professor Kaplan doesn't make this comparison or answer this question (much less define what he means by CEO pay).

Before we get to "how much" (this week) and "how pay should be structured" (next week) we thus need to ask what is the CEO's job and how do we measure that performance?

As I have argued, here and elsewhere, we need to redefine the CEO's fundamental job to be two things: balancing risk-taking and risk-management and fusing high performance with high integrity.

How then do we measure performance, risk management and high integrity --with measurements in all three areas contributing to fixed cash, variable cash and variable equity?

On performance, we need to look as closely as possible at the real economics of the corporation (immunized as much as possible from book-keeping manipulations and stock price fluctuations) by focusing on such items as cash flow, return on assets, return on invested capital, successful innovation and product development and economic value added, within multiple "accounting periods" (over one year, three years, five years).

On risk, we need to look, organizationally, who works in the function, whether their voices are heard as loudly as those who would spend the corporation's resources and where it reports (to the CEO/board on important priorities involving major financial risk). We need to understand the processes for assessing, spreaking and managing risk. We need to have a rolling three to five year "look-back" to see whether major economic decisions (contracts, transactions, derivatives, new products, planting the flag in emerging markets) performed on predicted performance or did exceeded or missed projections---and understand why.

On integrity, we should focus on adoption of key principles (see my attempt to articulate such principles in the book cited in my short bio) such as the consistency and commitment of the CEO and other top leaders or how well integrity issues are embedded in business operations); on implementation of key practices such as legal and ethical risk assessment and mitigation); on culture through such techniques as employee surveys and 360 evaluations; on comparison to peers (both across divisions with the corporation and with outside companies); and on annual goals and objectives (how are hard problems handled, were good hires made in sensitive positions).

Until we rigorously go through the exercise with each CEO of defining the job and the developing sound metrics for assessing how well that job was done, it is not possible to answer the next questions of "how much" or "how to structure."

One of the problems with the whole area of executive pay is exhibited by Professor Kaplan's contribution: it focuses on often irrelevant "others" and obscures the most fundamental questions of what should the CEO do and how should we measure that individual contribution.

- Posted by Ben Heineman
June 17, 2009 7:12 AM

Let me respond to Nell Minow and Ben Heineman.

I have to disagree with both of Nell Minow's comments.

First, there is a reason that the pay of other people matters. It affects the quality of whom you can recruit. If Nell does not like hedge fund managers, let's use lawyers and McKinsey consultants. A top law partner earns well over a million dollars as a lawyer. Eric Holder (our Attorney General) earned more than $3 million last year. If GE wants to hire a top notch lawyer as general counsel, then GE or any other top company is going to have to pay on the order of 7-figures to get a partner-level person. Presumably, the CEO is going to have to earn more on average than the general counsel. Similarly, a McKinsey partner earns well into 7-figures. If a company wants to hire someone of that quality, they are going to have to pay. While Nell may not like it, it is not difficult to see why a CEO of a S&P 500 company, managing 20,000+ people in the public spotlight is going to earn a median of $8 million. A competitive labor market guarantees it.
Second, while Nell wants to deny it, realized CEO pay is highly tied to stock performance because so much of their wealth is tied up in restricted stock and options. This was even true of Dick Fuld and Jimmy Cayne. They both lost hundreds of millions of dollars when Lehman and Bear Stearns failed.

I am a little confused by Ben Heineman's comments. As he should know, I clearly define all of my terms in my academic paper and the presentation that goes with it. These are both linked to in my comment. I encourage him to read them. http://faculty.chicagobooth.edu/steven.kaplan/research).
It also is confusing that he does not address my arguments at all, let alone contradict them. I tried to address two questions. The first question is whether CEOs are overpaid. Another way to state this is what does a company have to pay in order to get a high quality CEO? My answer is that the median pay of $8 million for a S&P 500 CEO is not obviously high and may be low. The reason for this is that the market for talented individuals in business and finance has markedly changed since 1980. If you want to get a law partner to become general counsel, you need to pay him or her. (As GE's former general counsel, I assume Mr. Heineman is familiar with this.)

The second question is whether CEOs are paid for performance? This is conventionally framed as whether CEO pay tracks firm stock performance, particularly long run stock performance. Looking at realized pay – the pay a CEO takes home – Josh Rauh and I find a strong relation between realized pay and long-run stock performance – 3-year or 5-year. While it is a fair point to mention other measures of performance –they have their pluses and minuses – that has not been the focus of the debate.

- Posted by Steve Kaplan
June 18, 2009 4:16 PM

Professor Kaplan and I have an important disagreement on what "performance" means. As his last note indicates, his research focused on whether realized pay tracked longer term stock performance (3-5 years). I argue that we need to redefine the CEO role and reward more than stock price increases along revised performance, risk and integrity lines. Professor Kaplan ends by saying: "While it is a fair point to mention other measures of performance –they have their pluses and minuses – that has not been the focus of the debate." Obviously, I submit that these other measures should be at the center of the now raging debate.

Further, I also submit that one cannot answer the question about whether CEO's are overpaid or underpaid until one properly defines desired performance (the behaviors being compensated and reviewed over time within the corporation and against appropriate peer companies, if they exist).

- Posted by Ben Heineman
June 24, 2009 7:57 AM

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