HOW TO FIX EXECUTIVE PAY

Regulating CEO Pay Is Not the Answer

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by Ira Kay

We're at a crossroads for CEO pay - and by extension for corporations and competition in general.

The conventional wisdom says executive pay played a substantial, perhaps dominant, role in the financial crisis and recession by encouraging excessive risk-taking. As a result, there's huge public support right now for the idea that the basic executive pay model should be changed that it should be rethought, reformed, legislated, and regulated. This is a natural reaction to unprecedented events. And the Obama administration is about to present its own philosophy on CEO pay in the form of compensation rules for twice-bailed-out companies.

But legislating and regulating executive compensation has the capacity to do real damage. Our research has shown that the traditional executive pay model using cash and stock incentives continues to work for the vast majority of companies. It motivates leaders to steer their companies toward high performance. Luck plays a part in whether or not the companies actually get there, but the pay-for-performance model certainly sets companies up to succeed. Our research shows that in general, high-performing companies' CEOs get paid a lot, and low-performing companies' CEOs get paid much, much less.

Furthermore, CEO pay is already self-correcting. Boards have heard the outcry from shareholders, activists, the media, and the public. All across corporate America, the compensation committee debates of the past few weeks have been notably different from previous years'. To borrow President Obama's language, the board members "get it." We survey directors annually and have found they have become far more conservative in making their CEO pay decisions.

An important factor prompting this change in board behavior has been the freezing up of the CEO labor market. This year, CEOs don't have as many employment alternatives as they used to. In past years, the intense competition for good CEOs helped boost executives' pay packages. In fact, a poor understanding of the executive labor market underpins much of the conventional wisdom about CEO pay. Many assume that some chief executives must browbeat their weak-willed boards into giving them lucrative deals--even in bad years. But in the vast majority of cases, that's simply not so. Boards do "buckle," in a sense, but only to the realities of the labor market. Big-company directors are convinced that the right CEO can add billions of dollars' worth of value for shareholders, and in most years, the right CEO is a scarce commodity.

CEO pay will self-correct in another sense too: Profits and stock prices are likely going to increase more modestly in the coming months and years, and that slower rate of growth will affect chief executives' realizable pay--the true value they earn in incentive and equity pay.

So I would suggest not a wholesale rethinking of the traditional executive-pay model but a more measured approach that specifically counters the role that pay may have played in causing excessive risk taking. As many have argued, perhaps it was the failure of the financial firms' risk models to identify the true downside risks that led to this crisis.

While this moment in history presents challenges for corporations, it also presents an opportunity for boards to get rid of executive pay components that irritate shareholders and employees. And that is what we

recommend. Directors now have more clout to stand up to CEOs and refuse things like lucrative severance packages in case of takeovers, and they have eliminated some prerequisites. CEOs often don't realize how big an impact some of these perks can have on people's attitudes. We recommend protecting core incentives and minimizing the irritants, with an eye on balancing the risk components in the pay program with the pay-for-performance components.

But our recommendations are always framed in practical, economic, rather than moral, terms. Outraged employees and investors are bad for the CEO and bad for the company. For example, if employees are annoyed at their leader, productivity and thus profitability might slip. What matters to me isn't whether there's a moral crisis in executive compensation but whether companies can stay competitive and balance pay for performance with the right risk profile.

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Ira Kay devotes only a few sentences to the problem of executive pay in the financial sector. But that sector is the core of the problem, and the rest of corporate America certainly must address the obvious problem of guilt by association.

The witch's brew of high leverage, poor risk management, creation of toxic assets and poor business judgments---all made more poisonous by excessive short term cash compensation (even if top execs also received longer term equity grants)---are unprecedented failures of financial sector directors and CEOs. The result: the credit and solvency crisis has led us to the edge of depression----and business credibility has eroded, trust has dissolved and re-regulation, first for the financial sector and perhaps for all publicly held companies, has, as we all know, great momentum.

As disturbing, few financial sector leaders have candidly addressed the obvious questions in public to provide a counter-weight to the understandable populist anger about pay: what happened, what were the failures, what are the remedies? Lloyd Blankfein, Goldman Sachs CEO, recently told the Council of Institutional Investors: "the past year has been deeply humbling….the loss of public confidence will take years to rebuild….decisions on compensation…look greedy and self-serving in hindsight…..Meaningful change and effective reform are vital and should naturally emanate from lessons learned." But what other business leaders have spoken out about the problems----much less about what needs to be done by the private sector itself?

Public regulation of executive pay and other governance issues for financial institutions (as well as numerous other reforms like counter-cyclical capital requirements and related leverage and liquidity restrictions) cannot be stopped. The era of financial deregulation is over: there will be a new balance between public sector regulation and private sector self-determination. This is especially so when the government has skin in the game by using taxpayer money to prop up private institutions. Business leaders can, perhaps, moderate the result—at least for corporations not receiving taxpayer money directly--- if they pose private sector alternatives that address the significant issues of risk and integrity raised by the financial crisis. General planglossian statements that the private governance system is self-correcting won't stop the regulatory train.

In broad outline, I believe boards must take four steps relating to executive pay---and forcefully advocate them in public through appropriate business associations or ad hoc groups of respected business leaders (current and retired) .

--Redefine the role of the CEO (perhaps this is "Back to the Future") so that the foundational tasks are to balance risk-taking (creativity and innovation for growth) with risk management (financial discipline) and to fuse this high performance with high integrity (law, ethics and values) to address legal, ethical, reputational and public policy risk.

--Institute new management development processes for corporate P&L leaders which put strong emphasis not just on achieving the numbers but on risk assessment and performance with integrity.

--Completely redesign executive compensation to measure and reward these redefined foundational CEO and business leader behaviors. Such a redesign would have both variable cash compensation and variable

equity held back or paid out over time as objectives relating to economic performance, risk management and integrity objectives are met, exceeded or missed. Such a system would be the death knell of both the huge annual cash bonus and the naked stock option or RSU tied solely to the market ---rather than to such appropriate measures as comparisons with peers and achievement of important economic goals (cash or return on assets or product development).

--Focus board oversight on the performance, risk and integrity issues in the near, middle and longer term which form the basis for executive compensation.

Until these kinds of interrelated governance reforms, including significant reform of executive pay, are propounded forcefully and credibly by the business community—with the important point that substantial granularity is inevitable given differences in companies and sectors---the regulatory express will roll on to public company destinations beyond the financial sector.

If ever there were a time when the financial sector and the broader business community has to speak out on a revised governance approach to performance, risk and integrity, and their relation to executive compensation, this is it. Mr. Kay's observation that good things are happening behind the closed doors of the board room won't do the trick.

- Posted by Ben Heineman
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