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What is the Best Approach to Executive Compensation?

Dissertation – Post Graduate Category

Submitted by:

Aishwarya Srinivasan Iyer

PGDM – Finance (2008-10 batch)

Institute of Management Technology, Nagpur

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1. Executive Summary

The view that incentive compensation plays an important role in driving the performance of organizations had begun to take root in virtually every culture in the world. Major corporations on every continent are adopting, the U.S.-type incentive plans that would spur their managers to work harder and smarter. But the truth is that most incentive plans, including the ones typically used in the U.S., do exactly the opposite of what their designers intend. They act as powerful brakes on performance, causing managers to be much more conservative than shareholders would prefer. Most of the time, when CEOs are paid compensated with stock options, and the options are deeply out of the money, they have a greater incentive to take higher risk. While not simple, it is possible to structure truly effective incentive systems that solidly align the financial interests of managers with those of shareholders, that improve motivation and morale, and that create an atmosphere in which managers constantly strive.

There has been a lot of rhetoric with respect to executives having a very short-term focus since executive compensation package is tied to short-term gains. Some ways that the Board of Directors, plan to focus more on the longer term is to have short-term bonuses or salaries paid in stock and require executives to hold the stock for two, three, four or five years before they can sell it and have these sort of longer-term performance objectives. It is recognized that for most of these top executives, the vast majority of their compensation is already tied to long-term stock price performance. Starting in the early to mid 1990s and through to recent years, the majority of a CEO's pay -- not only at a financial institution but at non-financial institutions in corporate America in general -- comes from grants of stock and options.

This report covers aspects of executive compensation such as, Should investors worry about absolute levels of pay? What is 'fair pay' for the executive? Are they already overpaid for what they do? Do managers respond differently to different compensation plans? What elements of compensation lead to superior corporate performance? How should CEO pay be correlated with performance? How sensitive is pay for performance? It concludes with stating the advantages of the best executive compensation system according to the author.

2. The Controversy Surrounding Executive Pay

Very few topics in finance have attracted as much scholarly attention as top management compensation. The acute interest in the subject can be attributed to the spectacular rise in CEO compensation in recent days and executive stock option explosion. However, some studies have found that there is no correlation between pay and performance.

i. The crackdown on executive pay: Too much or not enough

In October 2009, the Obama administration's "pay czar," Kenneth Feinberg, announced that the government will impose caps on compensation for the 25 highest-paid executives at seven companies that received "exceptional assistance" through the Troubled Asset Relief Program – including American International Group (AIG), Bank of America, Citigroup, Chrysler, Chrysler Financial, General Motors and GMAC. Under the new regulations, salaries will be reduced by an average of 90%, and total compensation (including bonuses and stock options) will be lowered by 50%. The reform also requires executives to buy stock that must be held for a number of years before they can cash out, which gets more to the heart of the system.

In the overall context of reforms in the regulations pertaining to executive pay issue after the financial crisis, Wayne R. Guay, Accounting Professor at Wharton is quoted saying, “The large financial institutions didn't run into trouble because they were overpaying their executives. The amount of compensation these individuals were taking home is not what caused this problem. The problem was these institutions had a lot of similar risk structures that got hit with some of the same underlying fundamentals in the economy, which caused all of them to experience substantial losses at a similar point in time”.

Talking about the linkage between excessive risk-taking and executive compensation, Guay says, “Executives have an incentive to take a risk when they are protected on the downside and have unlimited or substantial gains from the upside. Stocks don't really have that feature”. Tying an executive's compensation to stock doesn't provide substantial risk-taking incentives, at least for top executives.

The chain of command is of utmost importance, namely, Shareholders choose the directors to look after their interest. The directors then select an executive management team to look out for the shareholders' interest. Then the executive management team looks after the other employees, who look after the shareholders.

Economically the importance of executive pay is hazy, depending on what is thought to have caused the financial crisis. “One school of thought says that the crisis occurred because of

certain pay systems where executives took too many risks. They took options that were too short-term. While many people focus on pay levels and people getting paid too much in terms of raw numbers, the incentive structures seem to matter more”, Guay adds.

A big debate among academics and practitioners existed before the start of this crisis claiming that executives were setting their own pay. There is a board of directors acting on behalf of shareholders, which sets pay to maximize shareholder value. But the alternative view is that the CEO has his or her buddies on the board, which enables them to approve pay schemes that are good for the CEO but not the shareholders.

A prominent view – mainly proposed by **Xavier Gabaix and Augustin Landier** of NYU Stern School of Business - argued that the pay level is justified by competitive forces. The broader implications of changing pay is that if the amount of pay is reduced or if the managers are not incentivized enough, it might not be possible to recruit the best managers. One of the concerns that some shareholders have is that we are throwing the baby out with the bath water. “On the one hand, we have got a direct saving in the amount of salary. But on the other, what we are losing in terms of potentially better decisions may vastly outweigh this”, illustrates Alex Edmans, finance professor at Wharton.

Although executive compensation and risk-taking are closely tied, this is not the same as saying pay limits and risk-taking are closely tied. “While I agree that executive compensation is a big factor, this is about the structure of incentives rather than the actual level of pay. If we see the asymmetric risk-reward structure or the short-term nature of incentives being the driver of risk-taking, changing the level of pay misses most of the action”, adds Edmans.

ii. The Sensitivity of CEO pay to Performance

In a year that saw so many chief executives fail, Steven Kaplan, a professor at the University of Chicago's Booth School of Business, chooses chief executives who performed well this year to be **Raj Gupta** of Rohm and Haas Co., **James Skinner** of McDonald's Corp and **J. Michael Pearson** of Valeant Pharmaceuticals International.

A study of 2,000 CEOs by the compensation research firm The Corporate Library has ranked five CEOs as the "Highest Paid Worst Performers". The firm found that the chief executives of retailer Abercrombie & Fitch (Michael Jeffries), oil services firm BJ Services, cable company Comcast, International Paper and petroleum company Nabors Industries (Eugene Eisenberg) all earned "significant payouts despite what really was very poor performance

being delivered to shareholders," said Corporate Library senior research associate **Paul Hodgson**¹.

Exhibit 1: Top 10 Highest paid CEOs in 2009²

<u>Rank</u>	<u>Name</u>	<u>Company</u> ³	<u>Total Pay</u>	<u>Equity Pay</u>	<u>Percent change</u> ⁴
1	Roberts, Brian L.	Comcast Corp.	\$24,683,315	\$10,210,080	2
2	Stevens, Robert J.	Lockheed Martin Corp.	\$22,863,062	\$7,819,860	- 5
3	Maffei, Gregory B.	Liberty Media Corp.	\$22,244,366	\$18,016,012	16
4	Poussot, Bernard J.	Wyeth	\$21,182,603	\$16,325,880	
5	Weldon, William C.	Johnson & Johnson	\$21,125,456	\$6,431,489	- 3
6	Seidenberg, Ivan G.	Verizon Comm. Inc.	\$19,912,389	\$13,125,010	- 2
7	Williams, Ronald A.	Aetna Inc.	\$17,445,912	\$14,302,661	- 4
8	Ryan, Thomas M.	CVS Caremark Corp.	\$17,434,647	\$11,000,029	- 2
9	Clark, Richard T.	Merck & Co. Inc.	\$17,320,938	\$13,219,425	20
10	Strangfeld Jr., John R.	Prudential Financial Inc.	\$16,302,184	\$11,886,670	

As can be observed the **best performing CEOs are invariably not the highly paid**. Conversely, the highest paid CEOs rarely figure in the list of top performers.

3. Literary Review of Empirical Findings

¹ ABC News, 22 Sep 2009

² Data Source: *Equilar Inc*

³ Large and mid-cap publicly listed companies with headquarters or major operations in the 10-county region (Bucks, Chester, Delaware, Montgomery, Philadelphia, Burlington, Camden, Gloucester, Salem, New Castle)

⁴ Percent change is compared to the previous year's pay

Many academic studies have been conducted for testing the correlation between pay (as measured by salary and bonus) and changes in the market value of the firm. A study by **Marschak and Andrews**, in 1944 has reported that it is likely that CEO compensation and firm performance are correlated with the current realization of the unobserved firm-specific effects.

One of the most widely quoted studies on executive compensation is by **Jensen and Murphy (1990 a, b)**. They use a least squares regression to calculate the relation between the dollar change in salary and bonus and in the shareholder wealth for all companies with at least seven years of pay-change data from 1975 to 1988. They also estimate the changes in market value and the value of stock option holding. The outcome of their study is that there is essentially no correlation between firm performance and CEO pay. This "zero correlation" belief is based on the widely cited result that CEO wealth rises by only \$3.25 for every \$1,000 increase in firm value (Jensen and Murphy, 1990a,b) and findings that the elasticity of CEO salary and bonus with respect to firm market value is only 0.1. Their study matched the common belief regarding CEO compensation.

Contrary to this, using a new 15-year panel data set of CEOs in large U.S. firms, **Hall and Leibman** (1998) have reported a variety of pay-to-performance measures using a broad measure of CEO compensation including changes in the value of CEO holdings of stock and stock options. They have shown that CEO compensation is highly responsive to firm performance. In their study with a mean increase of 207% in compensation and a large increase in stock option awards along with the value of stock holdings, has approximately doubled pay-to-performance sensitivities over the period from 1980 to 1994.

Another study by **Kevin J. Sigler and Joseph P. Haley** (1995)⁵, testing for the influence of CEO pay on firm performance over a cross section of companies, finds a positive and significant connection between the pay of CEOs and the performance of their respective firms. Indicating a substantial rise in the relationship between CEO pay and bank performance, is another study conducted by **Crawford, Anthony J., Miles, James A., Ezzell, John R** (1995)⁶, focusing on three components of executive compensation, namely salary and bonus, stock option holdings, and insider stock ownership. For this study, 1976-

⁵ Managerial Finance Journal, Volume 21, Issue 2

⁶ The Journal of Business, University of Chicago Press

1988 data on the salary and bonus of 215 CEOs from 118 commercial banks and data on options and stock holdings of 75 CEOs from 37 commercial banks were gathered.

4. Various compensation systems

i. Fixed Salary and Bonus based on accounting measures

For decades accounting measures have been used as primary indicators of managerial performance with prior research documenting a significant relation between accounting based performance and executive compensation⁷. Most executive pay packets contain four components – a base salary, an annual bonus, stock options and long – term incentive plans. The base salary is determined based on the company's size, profitability, the executive's experience, education and past performance. Consideration is also given to compensation practices in comparable companies both within the industry group and outside. The annual bonus depends on actual performance on one or more measures like return on investment, net income, cash flow, and sales, EPS⁸ or EVA⁹. The executive does not get the bonus unless he meets a threshold. Further, the executive cannot earn unlimited amounts in bonus. That is, the bonus is capped.

Since the objective of a firm is to maximize shareholders wealth, the performance measure used should have high correlation with changes in shareholders wealth. Managers are commonly appraised on measures like return on assets, earnings per share and return on equity that does not capture value. Profit itself is not an appropriate measure of performance because it does not capture either the amount of capital used to generate those earnings or the required rate of return on capital.

ii. Executive Stock Options

Executive stock options are call options which give the holder the right but not the obligation to purchase a company's shares at a specified exercise price. These are mostly at- the- money- options i.e. the exercise price matches the stock price at the time of grant. They cannot be

⁷ Antle and Smith, 1986, Bloedorn & Chingos, 1991; Ittner, et al., 1997

⁸ Earnings per Share

⁹ Economic Value Added is the registered trade mark of Stern Stewart and Co; $EVA = NOPAT - (WACC * Net Assets)$

sold to a third party and they must be exercised before a stipulated period of time. Also many of them also have a vesting period before which the executive cannot exercise the option.

It is common place these days for senior executives to get substantial proportion of their compensation in the form of stock options. Last year's biggest pay went to **Sanjay Jha** of Motorola who was lured away from Qualcomm in August to try to turn around Motorola's struggling mobile phone business. Jha earned \$104.4 million in total compensation, although almost all of it - \$103.6 million - came from stock options and grants. Similarly, the top earner of 2007 was Oracle chief **Larry J. Ellison** who drew just a \$1 million salary, but realized \$182 million from the exercise of vested stock options.

The objective of incentive compensation is to make managers behave like owners. A potential source of conflict between managers and shareholders lies in their risk tolerance. Shareholders would want managers to take riskier projects because of larger upside potential whereas managers would want to limit downside because their career would be jeopardized in case of a failure. Another source of conflict lies in the time horizon of investments. If managers were rewarded on the basis of current profits they would have little incentive to invest in long-term projects even if it is desirable. The objective of the compensation plan is to reduce such conflicts. Options limit the downside while at the same time allowing participation in the upside because stock options are sensitive to the volatility of the stock price.

Although there are several types of executive stock options, the sensitivity of pay to performance is the maximum under the Mega Grant Plan¹⁰, where an executive gets options worth the present value of a multiyear plan. The value of the holding is highly sensitive to changes in stock price. Companies like Disney have instituted mega grant plan for its CEO, Michael Eisner.

A disadvantage of stock options is that they reward *all* managers whether they perform or not when the market rises. An executive who gets the option during a bull run can make money by just showing up. That is, the executive gets paid for *any* performance. The executive should be rewarded for returns equal to or better than those earned by the company's peer group or by market indexes. The exercise price could be tied to some benchmark index, i.e. indexed. Then the executive is not penalized when the market declines since the exercise

¹⁰ Hall 2000 a

price is reset, but is rewarded as long as he out performs the index. The number of options should be set in such a way that the executive gets the same value under both the schemes. As a thumb rule one may award two indexed options for every conventional option held.

iii. EVA based compensation

EVA is an accounting based measure of operating performance, which is difference between accounting earnings – with suitable adjustments for interest and some accounting methods – and the cost of capital used to generate these earnings. EVA aligns managerial and shareholders' interests by tying management compensation to improvements in EVA. There is a bonus bank feature in this system, whose intent is to filter large bonus swings and to defer the impact until it can be ascertained that they are associated with permanent changes in shareholder wealth.

EVA based performance linked compensation has several benefits. Since bonus is linked to change in EVA, it reinforces continuous improvement focus. The absence of caps in the pay off profile avoids the kinks that encourage undesirable behavior. The bonus bank feature, encourages longer-term focus, smoothens impact of business cycles and helps retain top performers.

iv. Employee Share Ownership Plan

The basic idea behind any ESOP is that common stock (or convertible preferred stock) is distributed to the accounts of employees and eventually passed on to them at retirement or departure from the firm. Although there are large tax-related benefits associated with ESOP's and also potential employee-related incentives that can lead to greater productivity, factors such as the required later repurchase of shares, the subsequent loss of corporate borrowing capacity, and the employee incentive to resist any action that can cause loss of job, etc must be considered.

Employee ownership is growing rapidly in many countries around the world, as a result of explicit government policies, changes in organizations of work and tightening labour markets and is found primarily in closely held companies.

A basic ESOP provides that companies can establish non taxable employee benefit trust to hold shares for employees. These trusts can be funded by the company by contributing new shares directly to them, contributing cash to buy shares. The company contribution in each

case is tax deductible. In return for tax benefits, the company must run the plans in defined ways that do not discriminate in favour of higher-paid employees. Employees do not get their shares until they leave the company, at which time they can shelter taxation of the shares by putting them in a retirement account. Since all the employees are eligible to receiving ESOPs, it is not a motivating factor in making them perform more efficiently, at least not for the executives.

5. Characteristics of a good measure of performance

The performance measure that all companies ought to use is some form of economic profit or residual income. It should correlate highly with changes in share values and encourage managers to invest in all projects with a positive net present value and reject all negative NPV proposals.

What every company needs is an incentive system that clearly, objectively, predictably and continuously rewards managers for creating shareholder wealth and penalizes them for destroying it. In my view, EVA is the very best performance measure to use in incentive compensation plans, but any similar measure of economic profit will be vastly superior to conventional accounting earnings. By linking bonuses to EVA, an incentive system that causes managers to think like and act like owners of the portions of the business they influence, is most effective. The “banking” feature transforms managers into owners. It also minimizes the opportunities for gaming the system by insuring that companies pay only for sustained increases in performance, and it stretches out a manager’s horizon, obviating the need for a separate long-term incentive plan.

6. Scope for future studies

Further studies pertaining to compensation of executives can be those that measure the empirical correlation between the compensation and the retention levels of executives. Studies can also be conducted to find the ability of firms to attract executives based on their compensation patterns.

7. Conclusion

While the stock price or returns generated from the stock accurately measures the performance of senior managers it is inappropriate for measuring the performance of business because the link between their actions and stock price is not clear. Instead, they should be rewarded for enhancing the value of the business unit. Since the value of a company is the sum of its constituent businesses, enhancing the value of each business unit leads to an overall improvement in value. The value of each business unit can be estimated separately (using the DCF methodology) and managers could be rewarded for shareholder value added. Each business has some leading indicators of value. Some companies use non-financial measures such as product quality, customer satisfaction and market share in performance measurement and compensation systems.

8. Summary

Compensation systems have three dimensions: level, composition, and functional form. The level of compensation determines the quality of workers that a company attracts. The composition of pay—how much is cash and how much takes the form of equity participation, in-kind fringe benefits, retirement savings, lavish offices, or perquisites such as cars and club memberships. The functional form of pay is the principal determinant of how compensation affects behavior and encompasses such things as the relative size of fixed versus variable compensation, and the determinants and composition of variable compensation. It determines what people work on and how hard they work on it. It also has an important impact on recruitment and retention of employees, and therefore determines the type of people in an organization.

Under the Fifth Pay Commission, the entry-level salary of an assistant professor at IIM-A¹¹ is Rs 12,000 a month while the maximum salary of a professor is Rs 22,400 per month which is pittance vis-a-vis the qualifications required and expectations. “A fresh assistant professor joining a top-25 US business school would receive a pre-tax salary of about \$135,000-\$170,000 (Rs 67-85 lakh) plus pension and healthcare. How do you get quality faculty without paying for it?”, says Gautam Ahuja

¹¹ Indian Institute of Management, Ahmadabad, India

Professor, Ross School of Business University of Michigan¹². This definitely has a negative impact on the morale of professors and difficulty in their retention with the IIMs.

If pay is highly variable, such as the low base pay and rich option packages offered by Silicon Valley startups, the firm will attract risk takers. If pay is essentially fixed, the firm will tend to attract bureaucrats.

What we saw in the wake of the financial crisis is a number of investment banks reforming their compensation schemes. UBS has a new compensation model where it links bonuses to long-term performance. Morgan Stanley, Goldman Sachs and some of the other investment banks followed suit by trying to lengthen the horizon of incentives.

¹² Business Standard, September 2009

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