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Executive pay

## Neither rigged nor fair

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Bosses' pay in the rich world is not a fix. But it is flawed

Jun 25th 2016 | From the print edition



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Bill Brown

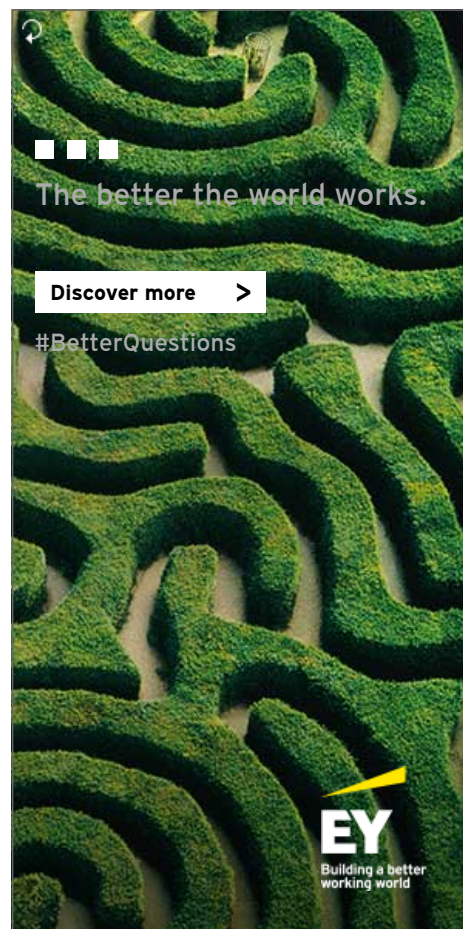
IN SEPTEMBER 2012 Marissa Mayer, newly installed as the CEO of Yahoo, an internet firm, and positively glowing with star power, met members of the company's compensation committee. She told the committee that she was in discussions with a potential candidate to be her right-hand man, and wanted to get guidance on "compensation parameters".

Ms Mayer described the candidate's expected compensation package as "\$15m per year (with \$40 million as part of that up front in a four-year grant) and a \$16m or more make-whole payment." Ms Mayer was authorised to continue negotiations in that meeting, and in one that followed. Just one tiny detail was missing: no one apart from Ms Mayer actually knew who the candidate was.

When his identity emerged, at the same time as the committee approved a draft offer letter, it was revealed to be Henrique de

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Bill Brown

Seeing what goes on inside firms when they make pay decisions is unusual. These details have come out only thanks to a court opinion issued in February in a case brought by investors in Yahoo who were miffed by the saga. And the scale of Mr de Castro's earnings was extraordinary. For those who think the system of executive pay in the rich world is working as it should, such egregious stories are just that—anomalies. “In a sample of lots of firms, some things will always look bad, and some unreported things will be great,” says Steven Kaplan of the University of Chicago Booth School of Business.

For critics, however, the exceptions are informative. “The market view of pay says that deviations are at the margin; that they are second-order, limited and transient,” says Lucian Bebchuk, an academic at Harvard Business School. “I think they are first order, and that the self-correcting mechanisms of the market cannot be relied on.”

Many would agree. In his doorstopper, “Capital in the Twenty-First Century”, Thomas Piketty, an economist, pins much of the blame for wider income inequality on pay rises for executives, managers and financial professionals. This month the French parliament handed shareholders a binding vote on CEO pay, following a row over compensation for the head of Renault, a carmaker. Shareholders elsewhere seem to be getting antsy too. British investors have delivered stinging protest votes against a string of firms. Shareholders have berated Volkswagen, a German carmaker, for paying bonuses to bosses who presided over its largest-ever annual loss.

This wave of dissent should not, however, obscure the fact that the concerns which animate shareholders and policymakers are very different. Public anger is fuelled by the size of bosses' pay cheques. Shareholders tend to care less about how much money managers take home, and more about whether pay and performance are genuinely in sync.

America is a case in point. Both of America's presidential candidates are gunning for bosses: Hillary Clinton has run ads lamenting excessive pay; Donald Trump has described



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pole to the top. And outside the firm, there are observable prices for the labour of senior executives, thanks largely to disclosures by listed firms. For example, the median pay level of an S&P 500 chief executive in 2015 was \$10.4m, according to Equilar, a research firm, a rise of 1% over the 2014 figure. (In practice, executives do not benchmark themselves against pan-industry figures but against their peers.)

These sorts of pay packages seem outrageous to many, especially when compared with wages elsewhere in the economy. Peter Drucker, the doyen of management theorists, reckoned that exceeding a 20-1 multiple of pay within a firm between executives and the average worker was bad for morale. Mr Drucker was worrying about the gap back in the 1980s, when the economy-wide difference between CEOs of big American firms and average workers was in the 40-1 range. How quaint that seems: depending on how you count things, the multiple now is somewhere between 140-1 and 335-1.

Even those who defend the market view of pay often say that these multiples may be too high from a social or ethical perspective. But their argument is that, from an economic perspective, they make sense. Pay is not set in isolation. Just like other parts of the labour market, what others pay sets an external market price. "You can argue that CEOs of public firms are in some senses underpaid," says Mr Kaplan, who points out that a senior partner at a blue-chip law firm or consultancy could earn several million dollars a year with none of the scrutiny, more job security and far fewer people to manage. Overpaid or underpaid, executives certainly know what the going rate is.

That transparency explains why it is hard for compensation committees to swing the axe on pay unilaterally, for fear that managers will go elsewhere. If executives do leave, firms are jolted into action. **A paper published in 2015 by Huasheng Gao of Nanyang Business School and colleagues looked at 510 job-hops in S&P 1500 firms between 1993 and 2011, in which an executive leaves one firm and joins another the following year. Total compensation for the executives left behind jumps by 46% on average.**

What this does not explain is why pay suddenly took off in the mid-1970s and kept on rising (see chart 1). Until then, executives in America were used only to modest bumps in pay; after then, massive salary increases became the norm. Here adherents to the market view of pay make their second argument: that returns to talent rose as firms globalised, became more complex and crucially, got bigger.

As companies grow, the impact of a top team which is a bit more talented is correspondingly more valuable. Driving up the value of Apple by 1% has a much bigger dollar effect than increasing the value of a much smaller firm by the same proportion. Firms should be willing to pay more for superstars as a result. According to research by Xavier Gabaix, Augustin Landier and Julien Sauvagnat, a trio of French academics, between 1980 and 2011 the

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once every three years. In America a rule change in 2006 prompted fuller disclosure of items such as the use of pay consultants; the Dodd-Frank act of 2010 handed advisory say-on-pay votes to shareholders in public companies. From Australia to Switzerland, the Netherlands to Sweden, the trend is strongly towards a louder shareholder voice.

Pay packages have changed as a result. Compensation for the suits comes in three flavours. First, a share of fixed pay, the salary that most employees take home; second, an annual bonus, paid on the basis of short-term performance targets; and third, stock-based long-term incentives (LTIs), which pay out over periods of multiple years. Over time, more and more of an executive's pay has come from these last two variable elements of compensation. And LTIs increasingly include specific performance triggers, often based on performing better than a group of competitors, rather than just requiring executives to stay with a firm for a certain period. In 2000 about 20% of large listed firms in America included performance-based awards in their pay packages; by 2015, that share had gone up to 80%, according to Equilar. As a result, unlike most workers, CEOs can see their pay move up and down year to year.

This, then, is the nub of the case that executive pay is no fix. There is competition for talent, and firms are willing to pay up for it. Talented executives can have an outsize impact on shareholder returns. And managers enjoyed huge gains even as shareholders won more control over the boards who set pay.

### Welcome to Lake Wobegon

The system of executive pay also suffers from flaws that push corner-office compensation higher than it would go in a truly efficient market. Well-functioning markets generally assume lots of transactions. But for executives, certainly right at the top of firms, it is a "thin market", with relatively few transactions, buyers and sellers. Analysis by the Conference Board, a research group, finds the average tenure of a CEO at an S&P 500 company close to nine years between 2001 and 2014. Over the past five years, the average number of CEO departures in this group has been 48.

That matters for a couple of reasons. One is that the risk of the most senior executives leaving for other competitors may not be as great as assumed. Almost half the departures last year were for retirements, for instance. Once people reach the very top of the tree, they tend not to move to other CEO roles. Yet these are also the roles that pay most—indeed, the pay gap with other senior executives inside firms has gone up over time.

The other implication of this lumpy market is that pay is not the expression of constant bargaining between a deep pool of buyers and sellers of executive talent, but of the outcomes of sporadic negotiations between boards and managers. Powerful CEOs, like Ms Mayer at Yahoo, can often command acquiescence. Research from ISS, a shareholder-

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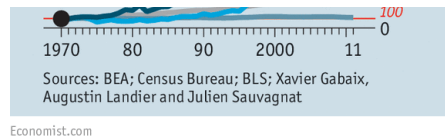
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effects, too. Share prices move around for all sorts of reasons: executives may benefit from market movements that they have little to do with. Because share prices have grown faster than GDP, consumer prices and wages, their use as a proxy has caused bosses' pay to pull away from that of average workers (see chart 2).



Although share-price increases are precisely what shareholders want from their chief executive, the effects can sometimes be perverse for investors. Stock options, which have value only if they go above a certain price, seem to be especially liable to manipulation that boosts share prices in the short run, but harms them in the longer term. Academics at the Mendoza College of Business at the University of Notre Dame found that option-heavy pay plans were correlated with a higher likelihood of product recalls. Executives, the researchers speculated, were being tempted to push out products to juice up the share price, content in the knowledge that they had nothing to lose.

Another classical trait of well-functioning markets is homogeneity of products. When you buy a certain type of fridge, it doesn't matter if it is one that came out of the factory on Tuesday or Friday. They are, to all intents and purposes, identical. Clearly, no one thinks that is true of people generally, nor of individual executives. But the very idea of a market price does rest on the idea that the very top bosses are, to some extent, interchangeable.

Yet the evidence behind this assumption is flimsy. The bulk of firms still appoint their executives from inside the ranks (see chart 3). And when boards do look outside, the rewards are not great. A research paper by academics from the University of Texas system looked at 192 S&P 1500 CEOs who had been hired from outside between 1993 and 2005. Their analysis showed that boards at these firms tended to go for hires whose prior employers had performed strongly, and that they paid a premium to entice these executives away. But there was no strong relationship between the performance of past and subsequent employers.



## A very particular set of skills

Adding to these frictions is another specific trait of executive pay. In other parts of the labour

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Castro to move jobs, you have to pay them more.

Now think about the interests of the compensation committee and the wider board of directors. The signal sent by a firm's hiring decisions matters. No firm wants to unveil a dud as their new leader; any firm that aspires to grow faster than the market average will be prepared to pay at or above the market rate. Executives are more like luxury goods than they are standard ones: paying more to land a big name can add prestige.

Any upward movement in one firm tends to ripple among its peers. Pay packages for executives often centre on a limited number of competitor firms. When compensation committees review their policies each year, they survey their peers' as well. Some firms are willing to underpay, but this is rare. "The prevalent practice is to be at or above the median, which means pay goes higher," says one compensation consultant, who defends this upward momentum nonetheless. "Some call it the ratchet effect, I call it a market effect. It's competitive and talent can move."

As for shareholders, the incentives to kick up a real fuss about executive pay are blunted by a few factors. First, dispersed ownership means that it is often hard for one investor to have a big impact: even a very large shareholder like a Fidelity or a BlackRock will often own only 3-4% of the firm. Second, passive investors are condemned to own the shares of some of the biggest firms, which means they value maintaining decent relationships with these firms. Third, many shareholders would much prefer managers not to be distracted by a row over pay. As a result, it takes a lot for institutional investors (public pension funds are much readier to dissent) to come out in open opposition to a firm. "Not voting 'no' does not mean we agree with the board," is the contorted phrasing of one large investor.

What all this suggests is that executive pay is a hybrid of different factors. Market forces play their part. But so do governance frictions, the mechanical relationship between firms in peer groups, and the signalling effects of lavish compensation. That will keep pay high, and the debate toxic.

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