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TIME, WRONG APPROACH**

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Fixing Executive Compensation: Right Time, Wrong Approach

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As a result of the executive compensation regulations imposed on companies taking TARP funding and the AIG bonus payments, the door has been opened for increased federal regulation of executive compensation. It is impossible at this point to predict how open the door is and whether or not there will be a comprehensive effort by the federal government to control executive compensation. Limiting pay in TARP companies could be the only action taken or the first of many actions that are triggered by the growing public anger over the pay levels of senior executives.

This is not the first time that congress has passed laws that attempt to regulate compensation. Indeed, perhaps the most comprehensive effort was the establishment of a wage and price control board during the inflation ridden 1970's. This effort like the ones that have followed are generally considered to have been ineffective. No doubt they changed compensation practices and levels, but not necessarily in the intended way. Indeed some have argued that past regulation efforts are partially responsible for the high levels of executive compensation that have resulted in today's demands for controls on executive compensation in the financial services industry and elsewhere.

In 1993 a change in the tax code limited the deductibility of CEO pay as a business expense. It meant that corporations could treat only one million dollars of salary as a business expense for each of its five top executives. Not covered by this provision are all kinds of incentive compensation. (e.g. bonuses and stock). Most agree that the effect of this action was to establish one million dollars as the minimum acceptable level of base salary for top executives.

Further, it appears to have stimulated the development the “pay for performance” plans that have contributed to the high level of executive compensation that exists today.

In 2006 the SEC issued a set of disclosure requirements for executive compensation that ordered companies to provide in “plain English” a view of their executive compensation plans. The result was to add long (often 30 plus pages) reports on compensation plans to proxy statements but it did little if anything to change how and how much executives are paid.

Effectiveness of Compensation Plans

Whatever regulations are proposed for executive compensation, the key question should be whether they are likely to be effective. In order to answer this question we need to specify what we expect executive compensation to accomplish. All too often many of the effects of executive compensation are ignored in debates about excessive levels of compensation. Instead of looking at what the objectives of an executive compensation plan should be, the debate almost always centers on the total amount of compensation that executives receive and in some cases how it relates to the performance of their companies. These are certainly important issues, but not the only ones that should be considered.

Most research on executive compensation suggests that there are four ways an effective executive compensation plan can contribute to organizational effectiveness. It is important to look at each of these and examine whether government regulation of executive compensation is likely to increase the degree to which executive compensation plans support them.

The four are: control the cost of compensation, attract and retain the right executives, motivate the right executive performance and present the right optics concerning executive compensation to key organizational stakeholders. Each of these deserves separate attention so let’s look at them in turn.

Control the Cost of Executive Compensation

Executive compensation is a business expense, as such it is appropriate to try to position it at a cost level that is “reasonable” and “competitive”. There is good reason to believe that executive compensation in many U.S. corporations is too high by some reasonable standards. For example, there are some corporations that have pay levels that are out of line with the U.S. market for executive compensation and reduce corporate earnings accordingly. It is also true that executive pay levels in U.S. based corporations are higher than those elsewhere in the world. This is particularly true in large corporations. As a result, U.S. based corporations have higher executive salary costs than their offshore competitors.

It is likely that federal regulation of executive compensation could reduce the total compensation of executives. By simply forbidding the issuing of paychecks above a certain amount and limiting stock grants and stock options, it is likely that government intervention could to some degree reduce the amount of executive total compensation.

Punitive taxes on high levels of executive compensation are another effective way the government can reduce the “take home” pay of executives. It is also true however, that if punitive taxes and compensation limits are put in, a great deal of effort will go into getting around them. Executives in most corporations have extensive corporate resources that they can use to assure that they get the maximum amount of compensation possible given any regulations that are put in place to reduce their total compensation level. New perquisites are likely to appear, indirect forms of compensation will flourish and executive compensation consultants will have a field day proposing new compensation approaches that will get around whatever regulations or punitive tax provisions are put into place.

At this point, it is impossible to know what approaches might be used to be sure that executives are highly compensated in the face of restrictions and regulations. Past regulations have led to greater use of stock, deferred compensation, golden parachutes and a host of other compensation programs. Still it seems likely that the right regulations could lead to some decreases in executive compensation.

Attract and Retain the Right Executives

Perhaps the most important thing that an effective executive compensation plan can do is to attract and retain the right executives. Attraction and retention is influenced by two features of any compensation package: its total amount and what forms of compensation are in it. Obviously the higher total amount of compensation, the more attractive a compensation package is to an executive. The features of the plan, that is whether it pays out in stock, cash, short term/long term, etc. also have a big impact on attraction and retention. Deferred compensation and long term pay plans can be powerful retention devices although may not be highly effective in recruiting senior executives. Stock options, stock grants and bonus plans can be particularly powerful retention devices if the company performs well and they pay out over multiple years.

For most companies, the key issue is finding the combination of base pay, incentive pay, stock and deferred compensation that will retain high performing executives. Often it is not simple to put together a package that appeals to the kind of high performing executives companies want to employ. It takes a relatively complex mixture of current incentive compensation and long term incentive compensation. This in turn requires cash and stock vehicles that are tied to the individual's performance as well as the company's performance. In short, packages often need to be complex and carefully designed. It is because of this that regulations are likely to be very counter-productive when it comes to attracting and retaining the

right executives for most companies. They are likely to interfere with creating pay packages that can be fine tuned and tailored to the attraction and retention needs of particular organizations and individuals. For example they may make it impossible to pay the kind of attraction and retention bonuses that are needed to get key executives from other firms or to keep them from leaving. They also may make it very difficult to pay the market rate for key executives and to lock them in with deferred compensation.

Pay regulations are likely to be particularly dysfunctional with respect to attraction and retention when only certain industries or parts of industries are regulated. This, of course, is the condition that has been created by the TARP pay cap that was passed by Congress in February. It puts all companies that are subject to the cap at a tremendous competitive disadvantage with respect to attracting and retaining the best executives. They simply cannot compete with private equity companies, foreign companies, etc. for the best talent. As a result the pay cap legislation is more likely to weaken the companies than to strengthen them at a time when their performance is key to the performance of the U.S. economy.

But what about a situation where all U.S. publicly traded corporations are regulated with respect to the level of executive compensation. This is possible, and may seem like a “good solution”, but it doesn’t solve the problem. With the many private companies and foreign companies that will not be limited in what they pay, there will be a brain drain from regulated companies to companies that for one reason or another do not fall under any government total compensation or pay package regulations.

Overall, the correct conclusion with respect to the effect of government regulations on executive compensation when it comes to attracting and retaining the right executives is that it will be more dysfunctional than functional. Perhaps the biggest concern is that it will put those

companies who are regulated at a competitive disadvantage to those who are not when it comes to attracting and retaining the best executives. This could be particularly dysfunctional if, as seems likely, the regulations focus on the very large publicly traded corporations that are critical to the national economy of the United States.

Motivate Performance

Perhaps the most complicated area when it comes to executive compensation is motivation. In some respects the way compensation affects motivation is relatively simple and straight-forward. When all is said and done, individuals tend to be motivated to perform in a particular way when they are rewarded for performing in that way. How motivated they are is very much a function of how clear the connection is between performance and reward and of course how large the reward for performance is. It is this very rationale that has led to large bonus payments for executives and very large stock plans. Incentive pay and stock constitute well over half the compensation of almost all corporate executives today. Indeed one could argue that many of the problems in the financial industry today are the result of pay plans motivating performance, the wrong kind of performance.

It is almost certain that the motivational power of executive compensation will be dramatically reduced by the provisions of any effort to control executive compensation. As the many failures of executive compensation plans in the past have proven, it is difficult to get the right performance measures in place when it comes to executives and to be sure that they are paid adequately for the right behaviors. Government regulation is likely to make it more difficult. Indeed if there are limitations on how much executives can make it may lead to the reduction or elimination of incentive compensation for executives. Instead of focusing on designing incentive compensation plans, companies are likely to focus on finding ways to

maximize executive pay under the regulations. Few companies are likely to put great amounts of executive compensation at risk when compensation is seen to be low because of government regulations.

Often the suggestion is made that executive compensation should be limited primarily to bonuses and stock awards that are deferred in order to optimize the focus on long term corporate performance. It is argued that combining this with the absence of large severance packages produces the right package of incentive compensation. There is a lot of truth to this, but ultimately the issue is whether this is best accomplished through government regulation and whether it fits all organizations.

It is hard to imagine a series of government regulations and interventions that would create a situation in which most companies would end up with incentive compensation packages that fit their particular needs for performance. It is very much like the situation with respect to attracting and retaining the right executives. There are some general ground rules that can be set, but it is hard for government to specify the right kinds of executive compensation plans given the multitude of situations that companies find themselves in and the multitude of business strategies that they have.

Overall, it is hard to imagine regulations that would make incentive pay plans for executives more effective on a large scale. There is a chance that by specifying certain features that are not allowable, like golden parachutes that reward failure, some malpractices can be eliminated, but that is about as far as it seems reasonable to take regulation with respect to incentive pay.

Impact on Corporate Culture and Reputation

The high level of executive compensation in the United States, especially when it is combined with poor organizational performance, has led to a negative image of the effectiveness of companies and has undermined the credibility of many executives. Particularly critical with respect to the amount of executive is the difference between the pay of top executives and the pay of lower level employees. This has been increasing for over two decades. In 2007, it was over 500 to 1 in large U.S. corporations; the highest in the developed world and in history. It is possible that by limiting the pay of senior executives their pay level will become less of an issue with employees, investors and the general public. This in turn might make them be seen as more effective leaders and their organization as being better managed.

There is little doubt that when CEO's pay is more in line with that of other employees, it can increase their credibility as a leader and their credibility with investors. This has happened in companies where CEOs have restricted their total compensation to a level which is more in line with that of others in the organization and have been careful to create executive compensation packages that only reward them when the organization's performance warrants it. It gives them the ability to say they are in the same situation as the rest of the workforce and is often cited as an excellent leadership practice. Although leadership effectiveness is a subtle and hard to measure positive outcome of lower and better structured executive compensation plans, it is an important outcome.

Ironically, if regulations are implemented that force lower compensation levels on executives it may do more to subtract from the image of executives who voluntarily take lower and more appropriate compensation packages than it does to improve the image of others. There is a real danger that they will no longer get credit for having the right executive compensation

pay level because in essence they will have to follow the government regulations like everybody else and no longer will be distinctive leaders who make good choices about their compensation.

Further, it is unclear that forcing executives to lower their compensation will give them any additional credibility or lead to them being more positively regarded by the workforce. It may have some effect because it will force them to “live more like the rest of the world” particularly if they do not have as much access to private jets and extraordinary perquisites, but they will hardly get credit for the downsizing of their personal compensation if it is mandated by the government.

Overall there may be more positive than negative effects from the government’s limiting executive compensation when it comes to the public’s regard for executives and to some degree for the regard they receive from their employees. Their very expensive lifestyles will be cramped and some of the perks that they have traditionally received may disappear. The negative effect will be the loss of positive regard for those executives who voluntarily downsize their compensation packages. Of course they can still do this by going beyond the regulations and undoubtedly some will.

Perhaps the best overall conclusion with respect to the impact both inside and outside of organizations, of regulations that reduce the total level of executive compensation is to say that they will be on balance positive but not particularly large or significant. What clearly would be much better is voluntary reductions on the part of executives.

Right Approach

The scorecard with respect to the likely impact of government regulation of executive compensation is not favorable. This raises the question of whether there is a better alternative, I think there is. Executive compensation is the responsibility of corporate boards; they need to do

a better job, but are unlikely to unless some corporate governance changes are made. My research shows that 31% of board members feel CEO pay is too high in most cases; another 47% feel it is too high in a few high profile cases. These feelings are unlikely to lead to action, however, since 85% feel their companies' CEO pay program is effective. There are two key governance changes that might lead to boards creating more effective executive compensation plans.

The first is to require that all boards separate the role of CEO and board chair. This is common in Europe and it may not be accidental that compensation levels are much lower in Europe. In Europe, however, the chair is often a former CEO of the company and cannot be described as an independent chair. In order to have an effective chair, the chair needs to be independent of the company and its executives. This is more likely to lead to a board that makes tough decisions about how executives are paid.

The second change is putting executive compensation plans to a vote of the shareholders, for whom the CEO and top executives ultimately work. Because shareholders are "the boss," they are the logical ones to determine CEO compensation. A first step, which has been taken by less than a dozen major companies, is to make the vote advisory. If this doesn't constrain CEO compensation, then it is important to move on to a mandatory shareholder vote on all top executive compensation plans.

There are a number of pros and cons associated with shareholder votes, but it is the change most likely to leave companies with the opportunity to design effective compensation plans without government intervention—and at the same time satisfy shareholders with respect to the level of CEO compensation. If it fails to have its intended affect then and only then should we consider government mandated restrictions on executive compensation payments.

One final thought: there is a chance that by moving now to reduce executive compensation levels and improve corporate governance, CEOs and boards can prevent further government regulation of executive compensation. Compensation levels did drop in 2008 and unless boards change their companies executive pay plans most likely will be much lower in 2009. Given the performance of most companies during this period, lower levels of executive compensation may be just what the doctor ordered with respect to establishing that executives are fairly and reasonably paid.