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Are Executives Paid Too Much?

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For several decades there as has been an on again off again debate about whether executives in U.S. corporations are paid too much. Recently, the issue has come front and center as a result of the high bonus pay outs to executives in some major financial institutions. There have been congressional hearings, government oversight of pay in financial institutions, numerous newspaper and magazine articles criticizing the compensation of senior U.S. executives and an increasing level of shareholder “outrage” and activism. Criticisms include not only the amount of cash and stock compensation executives receive but also the benefits, perquisites, retirement packages, and severance packages they receive. In short, virtually all elements of executive compensation have recently come under scrutiny from the perspective of whether executive compensation is appropriate in its form and its amount.

At ground zero, when it comes to the debate about how and how much executives should be paid, are corporate directors. They decide how and how much executives should be paid. During the current debate about executive compensation, relatively little has been heard from them. In order to find out how they feel about the current situation and what should be done about it, this year’s Center for Effective Organizations survey of Fortune 1000 corporate board members focused on executive compensation. Responses were received from 140 board members.

Let’s start our look at the survey results by considering a question that asks about the amount of CEO compensation. We first asked this question in our survey in 1998, at that time 25% said they felt that CEO compensation is too high in most cases. In 2009, the percentage saying this increased to 35%. Thus, it appears that more and more board members feel that CEO compensation is too high. But, this is still a minority view, the majority of board members in both 2009 and 1998 checked the alternative response of “about right except for a few high profile cases”. Thus our data suggest that board members are increasingly uncomfortable with the level of CEO compensation but that there is not a strong feeling among most board members that it is too high in most cases.

A second question on the survey probed more deeply into the question of compensation amounts by asking separately about cash compensation and total compensation. When asked whether cash compensation should be increased or decreased, most board members (62%) favored no change. In other words, they felt comfortable with the level of cash compensation. When asked about CEO total compensation, the data look quite different than they do for cash compensation. Only 38% responded that no change is appropriate while 48% think it should decrease. There is strong support for increasing the relationship between CEO pay and performance. Eighty-three percent say it should be increased.

What parts of the CEO total compensation package do board members think should be decreased in order to decrease CEO total compensation? The answer is clear in the survey data. Board members think the benefits and perquisites that CEOs receive, their retirement packages and their severance packages should be reduced. The strongest support is for decreasing their severance packages, 74% believe that they should either show a small or a major decrease while 59% feel benefits should decrease and 52% feel retirement packages should decrease.

It is quite clear that board members feel strongly that CEO total compensation needs to be, at the very least reallocated, and in some cases reduced. But will boards actually reduce executive total compensation? This may be just what happens. After all, board members are the ones that approve the compensation packages for top executives in corporations and are in a position to make it happen, but there is another question on the survey, which raises the possibility of little or no change.

Overall board members appear to be quite satisfied with their companies CEO compensation program, 86% rate the programs as effective or very effective. This is a very positive rating and is up from 76% rating them as effective or very effective in 2006. Apparently, there is a “not my CEO” syndrome that is getting stronger, possibly as a result of board members having to defend their pay decisions. Given the high level of satisfaction with the existing plans in their companies, it seems unlikely that board members will voluntarily make major changes in their company’s executive compensation programs even though they feel executive compensation in general is too high.

<u>Possible Changes Impact on Effectiveness</u>

A number of proposals have been offered concerning regulatory changes that would affect how the compensation of senior executives is determined, what forms it takes, and how large it is. The key issue, of course, is what impact the changes would have on the effectiveness of executive compensation plans. Table 1 shows the opinions of board members concerning how some changes in the way executive compensation is determined would impact the effectiveness of compensation plans. .

Several questions ask about how changes in the relationship between pay and performance would impact effectiveness. The answers to these questions indicate that board members think a stronger link between CEO pay and performance would have a positive impact. A high percentage think that tying pay more closely to company performance would have a positive impact and a slightly smaller percentage believe tying the individual performance of executives to pay would have a positive impact. Overall, board members feel that in order to increase the effectiveness of compensation programs the link between CEO compensation and performance should be made stronger and be based on both individual CEO performance and overall company performance.

The survey results show that there is very significant support among board members for being sure that boards have the kind of independent membership that allows executive compensation decisions to be made on an "objective" basis. Board members feel that having independent board chairs, having more independent boards, and having independent directors on compensation committees is likely to increase the effectiveness of executive compensation programs. Presumably, they feel these practices will lead to better decision making about the nature and structure of pay plans as well as how much individual executives should be paid.

The survey also asked about direct government intervention into how executive compensation plans are approved and the possibility of limiting the total amount of executive compensation. The reaction to these government interventions is very negative. It is most negative in the case of government imposing limits on executive compensation amounts. Seventy-one percent say it would lead to a great decrease in the effectiveness of executive compensation plans. In many respects, this is not surprising since previous efforts to limit executive compensation have typically not had the effect of limiting executive compensation or making plans more effective. In fact, they seem to have led to the creation of new ways to get money to executives that are not necessarily effective from an organizational and individual performance perspective.

Board members are also not enthusiastic about shareholder votes on executive compensation plans. They are slightly more favorable toward advisory votes than to mandatory votes but in general do not feel shareholder votes on executive compensation plans will lead to more effective plans. This is not surprising due to the fact that votes by shareholders decrease the power of boards and create a situation where “non-experts” are voting on very complicated executive compensation plans. This does not mean that it would not be effective in reducing the amount of compensation that executives receive. Having these votes may in fact cause boards to be a little more conservative in the plans that they actually develop and put to a shareholder vote.

Where do we go from here?

It is easy to make the case that executive compensation plans in the United States need to be improved. There is even some consensus among board members with respect to what directions they should move in. For example, there is an agreement that they should be more performance based, should have less of the total amount of compensation committed to retirement, severance packages, perquisites, and benefits. There is also agreement that, at least in some cases, executives are paid too much and are paid inappropriately. But, and it is a big but, there is the “not my CEO” syndrome that may prevent change.

What will it take to get executive compensation plans to change in the right direction? Will it take significant government intervention? Will boards initiate change on their own because their dissatisfaction gives them the motivation they need to improve how executives are paid? Will activist shareholder groups come to the forefront and demand the revision of executive pay plans? It is impossible to answer these questions at this point. Indeed, it is not even certain that any change will occur.

Quite possibly little or no change will occur because the opposition to change is too strong. Previous efforts directed at changing executive compensation have been ineffective and have lost momentum. The same thing may well happen again particularly if, as a result of the current recession, the amount of executive compensation drops dramatically and therefore less attention is focused on executive compensation in the press and in congress. The alternative, of course, is that CEO compensation does not drop as a result of the poor performance of corporations during the current recession. As a result calls for reform in executive compensation may become stronger and serve to mobilize congressional and regulatory actions that change how executive compensation plans are designed and administered. If this happens, boards will have no one to blame but themselves because of their failure to reform executive compensation.

Perhaps the best way to summarize the results of the survey is to say that board members do see a problem with executive compensation and do have opinions about the kind changes which will improve it. In many respects, boards favor making changes that are likely to improve executive compensation programs: increasing the relationship between pay and performance, reducing retirement packages, reducing severance packages, and reducing benefits. If these changes are made, it is very likely that the executive compensation policies of companies will be looked upon much more favorably by investors and the critics of executive compensation pay programs. If these changes are not made, some of the things that boards most oppose may occur. We may not see government imposed limits on the amount of executive compensation but we could very well see more shareholder votes on compensation plans and other regulatory moves which limit the freedom of boards to determine the compensation of executives.

Table 1						
Impact on Effectiveness	**Great Decrease**	**Moderate Decrease**	**No Change**	**Moderate Increase**	**Great Increase**	**MEAN**
Mandatory shareholder approval of all executive compensation programs	29.1	29.1	26.8	12.6	2.4	2.30
More independent Boards	0.8	10.9	37.2	38.0	13.2	3.52
Independent Board Chairs	0.8	12.4	45.7	29.5	11.6	3.39
Only independent directors on compensation committees	1.6	7.0	42.2	30.5	18.8	3.58
Tying pay closer to company performance	3.1	13.2	12.4	45.0	26.4	3.78
Tying pay closer to the performance of individual executives	3.9	14.8	18.8	44.5	18.0	3.58
Advisory shareholder votes on all executive compensation plans	17.2	32.0	37.5	10.2	3.1	2.50
Government imposed limits on executive compensation amounts	70.9	14.2	11.8	2.4	0.8	1.48