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## Alternatives for Establishing Executive Compensation Levels

**Michael S. Kesner, Principal**
**Deloitte Consulting LLP**

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# Overview

- Critics of executive compensation often cite the "ratcheting effect" created by pay benchmarking. In Berkshire Hathaway's annual report, Warren Buffet refers to the fictional consulting firm, "Ratchet, Ratchet, and Bingo" as being at least partially responsible for high CEO pay.
- Compensation committees have asked, "what, if any, alternatives are there to using benchmarking studies to determine pay?"
- This sections focuses on three alternatives for determining total compensation:
    - Internal Pay Equity
    - Wealth Accumulation Targets
    - Profit Set-Aside

## Internal Pay Equity

- Internal pay equity uses the relationship between the CEO's pay against one or more layers of the company's employees (most often the other named executive officers and average employee) to evaluate CEO pay.

- Advantages of setting CEO pay using internal pay equity:
  - Removes concern about CEO pay being driven too much by competitive market data and outside consultant surveys and helps mitigate market biases.
  - Restores fairness internally.
  - Addresses internal disaffection and disconnect between the CEO and a company's senior managers.
  - Specifically addresses ISS guidelines, which were recently revised to focus on "internal pay equity disparity" as a basis for recommending a "withhold vote" for the CEO and the entire board.

- Setting a reasonable standard of fairness for CEO pay: [1] [2]
  - Some recent research shows that, ideally, the CEO should be paid roughly twice the amount paid to the next management level (i.e., the direct reports or NEOs).
  - Moody's Investors Service reported that in their view any CEO to NEO pay equity multiple in excess of three times is a "red flag" in their process for review of credit and corporate governance risk.
  - A study performed on 2,000 companies within the Russell 3000 identified that CEO to NEO median pay multiples were in the 3 to 27 times range—with some CEO pay differentials to individual NEOs as high as 50 times or greater. More than 800 companies (40%) in the group were considered high-pay-multiple outliers.

[1] Source: WorldatWork - MVC Associates article on, "Internal Pay Equity Key to Fixing a Broken CEO Pay System."

[2] Source: Compensation Standards – Quarterly Newsletter Winter 2007.

## Internal Pay Equity (cont.)

- In conducting an internal pay equity analysis, it is important to check internal pay ratios against all pay elements.
  - At quick glance, the cash component at many companies may give the impression that the ratios are in line. However, taking into account the equity component and post-employment benefits generally provides a more accurate picture.
  - It may also be necessary to focus on amounts accumulated from past equity grants or to be earned from outstanding incentives (i.e., wealth accumulation). This can help uncover additional ongoing inequities or unintended amounts/outcomes.
- Since no two companies are alike (i.e., different structures and cultures, etc.), assigning an appropriate internal pay ratio will be up to each compensation committee to decide. It is generally recommended that the company perform a historical internal pay equity analysis—going back several years—to see what a company's ratios were before they started diverging significantly. Furthermore, it helps document the events or pay elements that caused the divergence.
- Dupont has used a 2x multiple to establish the CEO's base salary compared to the next level of executives. Jeff Immelt of General Electric has been widely quoted as supportive of maintaining a multiple to 2-3x.
- The risk with this approach is the resulting pay could be out of line with the CEO's market rate of pay. Thus, the CEO could be vulnerable to outside recruitment if his or her pay package is a key element in their decision to remain with the company.
- The following page includes a summary of internal pay equity in the banking industry prepared by Equilar.
  - Interestingly, large, mid-size and small banks all pay the CEO approximately 2x the next four highest paid executives (at the median).

# Internal Pay Equity: Total Direct Comp

| Total Direct Compensation (in $000) | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Market and Year | CEO | | Next Highest Paid Executive | | Average Four Highest Paid Executives | | CEO Total as Multiple of | | | |
| | | | | | | | Next Highest | | Four Highest | |
| | Average | Median | Average | Median | Average | Median | Average | Median | Average | Median |
| Large Banks, 3-Year Average | | $4,712 | | $2,823 | | $1,747 | | 1.67 | | 2.34 |
| 2006 | $9,969 | $4,338 | $6,250 | $2,967 | $4,438 | $1,793 | 2.10 | 1.69 | 2.88 | 2.27 |
| 2005 | $9,284 | $4,273 | $5,912 | $2,568 | $4,039 | $1,811 | 1.98 | 1.69 | 2.78 | 2.38 |
| 2004 | $8,153 | $3,795 | $5,281 | $2,390 | $3,666 | $1,671 | 2.12 | 1.64 | 2.89 | 2.36 |
| Mid-Size Banks, 3-Year Average | | $1,302 | | $735 | | $579 | | 1.56 | | 2.10 |
| 2006 | $2,304 | $1,107 | $1,428 | $718 | $929 | $546 | 1.80 | 1.51 | 2.34 | 2.04 |
| 2005 | $2,601 | $1,284 | $1,412 | $727 | $969 | $540 | 1.98 | 1.57 | 2.63 | 2.23 |
| 2004 | $1,657 | $1,089 | $1,135 | $618 | $742 | $484 | 1.80 | 1.58 | 2.34 | 2.03 |
| Small Banks, 3-Year Average | | $946 | | $621 | | $424 | | 1.54 | | 2.14 |
| 2006 | $1,930 | $861 | $1,467 | $544 | $891 | $392 | 1.80 | 1.48 | 2.47 | 2.12 |
| 2005 | $1,850 | $887 | $1,268 | $547 | $774 | $402 | 1.81 | 1.63 | 2.45 | 2.20 |
| 2004 | $1,426 | $689 | $1,149 | $495 | $756 | $343 | 1.68 | 1.50 | 2.23 | 2.10 |

## Wealth Accumulation Targets

- Another approach for (indirectly) determining pay levels is to establish wealth accumulation targets for the CEO and other senior executives. As the executives reach or exceed their respective wealth accumulation targets, pay is leveled-out or reduced, irrespective of what the benchmarking data suggests.
  - Base salary increases, future equity awards and accruals under the pension would likely be the first elements of compensation that would be affected.
- The advantage of this approach include:
  - Limits pay due to offset stock price results far in excess of expectations.
  - Restores employee and investor confidence that pay is being closely monitored.
  - Attempts to answer the question, "how much is enough?"
- Critics note that establishing future pay based on accumulated wealth is unfair as it penalizes the executives for success.
  - Of course, to blunt this criticism, it would be possible to establish wealth accumulation targets on a "sliding scale," where, depending on company performance, the target could be higher if the company performs above median of the S&P 500 or other benchmarks during the executive's tenure with the company.
  - To illustrate, "wealth accumulation of $50 million times the company's TSR / S&P 500 during the last five years."
- Wealth accumulation "caps" could eventually result in below-market pay for senior executives, which could leave them vulnerable to outside recruitment.

## Profit Set-Aside

- A third alternative approach for establishing executive pay levels is to base it on a percentage of company profits (or rate of earnings growth).
  - This approach is a key factor in professional services firms, such as investment banking, consulting, etc.
- Using a predetermined percentage of profits to determine the value of the merit pool, cash bonus and equity awards ties company performance and executive compensation in a direct manner.
  - The pool of funds available for bonus and equity awards is determined based on a percentage of the company's pre-tax and pre-compensation earnings.
  - Amount is then split into a cash and equity pool.
  - The pool is then allocated to executives based on their performance.
- Advantages to using profit set-aside in determining executive compensation:
  - Ties the compensation of senior executives to the success of the firm.
- Possible disadvantages include compensation far in excess, or below market levels depending on company performance and the divergence of company profits with stock price growth.

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