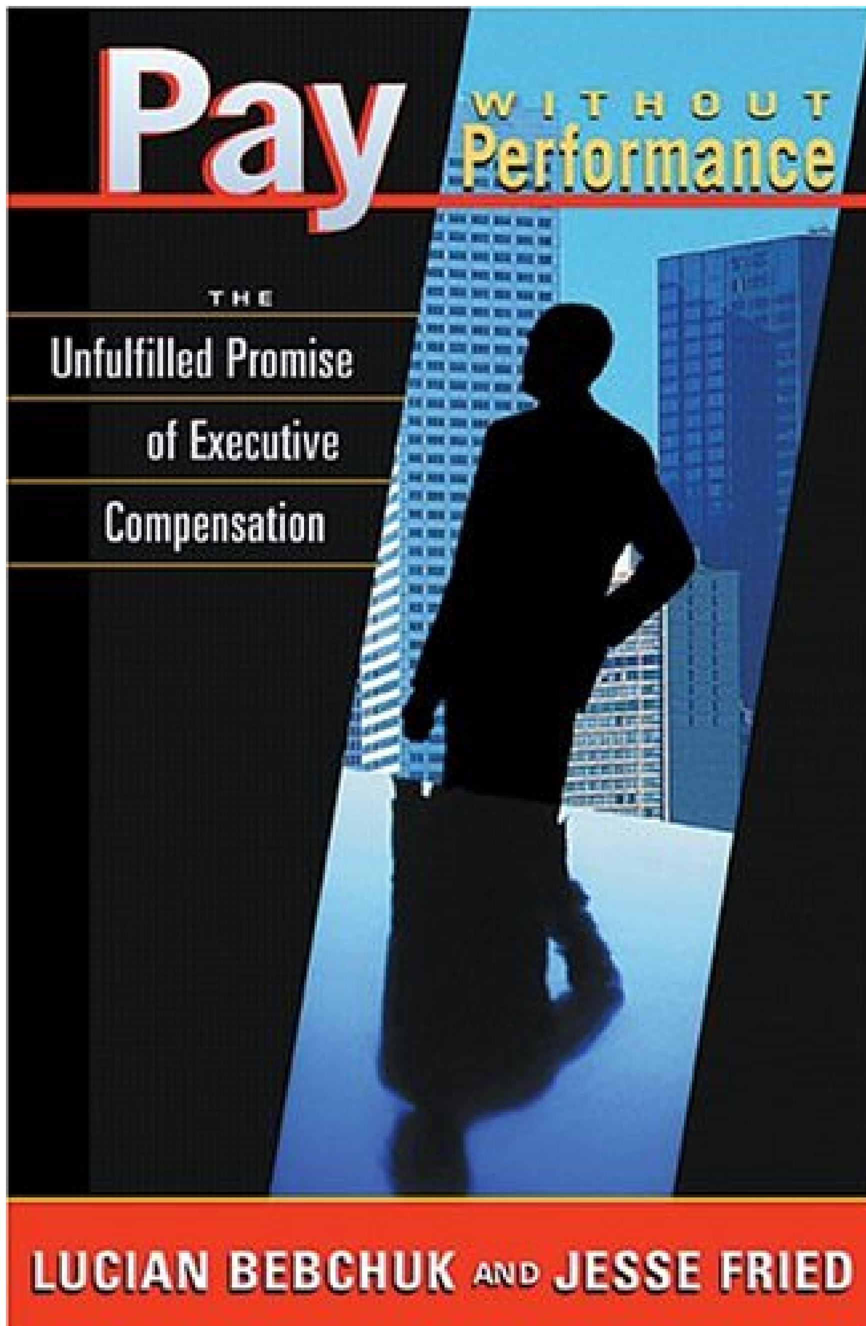

Paying for Performance

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October 31, 2005
Chicago

For fuller exposition of views on the subject:
Pay without Performance (Harvard University Press, 2004)

The Stakes (1)

Issue is not merely symbolic. Amounts at stake are substantial:

- Bebchuk-Grinstein (2005):
  - Aggregate top-5 pay during 1993-2003 about $250 billion
  - 10% of aggregate corporate earnings during 2001-2003 (up from 5% during 1993-1995)

Thus, if compensation levels could be reduced without weakening incentives, which we suggest is the case, effect on firm value could be significant.

The stakes (2)

- Excess pay is not the only or even principal cost. Our book shows that current compensation arrangements:
  - Dilute incentives to serve shareholders
  - Distort incentives – provide some perverse incentives, thus undermining rather than enhancing value.

Decoupling Pay from Performance (1)

- Rise in executive compensation has been justified as necessary to strengthen incentives
- Financial economists have applauded: Shareholders should care more about incentives than about the amount paid executives.

  "It's not how much you pay, but how" (Jensen & Murphy, 1990)
- Institutional investors have accepted higher pay as price of improving managers' incentives

Decoupling Pay and performance (2)

But the devil is in the details: managers′ compensation is less linked to performance than is commonly appreciated.

Managers′ own performance does not explain much of the cross-sectional variation in managers′ compensation.

Firms could have generated the same increase in incentives at much lower cost, or used the same amount to generate stronger incentives

Decoupling Pay from performance (3)

Factors contributing to the weak link between pay and managers' own performance:

(1) The historically weak link between bonus payments and long-term stock returns.

(2) The large amounts given through performance-insensitive retirement benefits.

(3) The large fraction of gains from equity-based compensation resulting from market-wide and industry-wide movements.

Decoupling Pay from Performance (4)

(4) Practices of “back-door re-pricing” and reload options that enable gains even when long-term stock returns are flat. (5) Executives′ broad freedom to unload vested options/restricted stock.

(6) “Soft landing” arrangements for pushed out executives that reduce the payoff differences between good performance and failure.

And more …

Paying for performance (1)

Reduce windfalls from equity-based compensation:

- Filter out some or all of the gains resulting from market-wide or sector-wide movements.
- Can be done in various ways; indexing is only one option.
- Move to restricted stock increases windfalls – restricted stock is an option with an exercise price of zero.

Paying for performance (2)

Reduce windfalls from bonus compensation:

- Filter out some or all of the improvements in accounting performance resulting from market-wide or sector-wide movements.

[E.g., look at increase in earnings relative to peers.]

Tie equity-based compensation to long-term values:

- Separate vesting and freedom to unload: require holding for several years after vesting (not until retirement).
- Prohibit contractually any hedging or other scheme that effectively unloads some of the exposure to firm returns.
- Limit the ability of serving executives to time sales.

Tie the performance-based component of non-equity compensation to long-term values:

- Assuming it is desirable to link pay to improvement in some accounting measures, don't link to short-term (e.g., annual) changes – can lead to gaming and distortions or at least to decoupling of pay from long-term changes in value.
- Claw-back provisions that reverse payments made on the basis of restated financial figures: "if it wasn't earned it must be returned."

Paying for Performance (5)

- Rethink termination arrangements:

  Current arrangements provide “soft landing” in any termination that is not for fault, defined extremely narrowly. This is costly – reduces the payoff difference between good and poor performance.

Consider:
-- Broadening the definition of “for cause” termination
-- Making the severance payment depend on the performance during the executive’s service.

Paying for Performance (6)

Rethinking pensions:

Bebchuk and Jackson (2005) document the magnitude of CEOs′ pension plan values:

- The ratio of executives′ pension value to the executives′ total compensation (including both equity and non-equity pay) during their service as CEO had a median value of 34%.
- Including pension values increased the median percentage of the executives′ total compensation composed of salary-like payments during and after their service as CEO from 15% to 39%.

It is unclear that this form of compensation has a good economic rationale – note that, for other employees, firms have been moving to defined contribution plans => Boards should re-examine whether retirement benefits are an efficient form of compensation.

- Avoid terms that penalize dividends
  - Under current option plans, terms are not updated to reflect payment of dividends – executives bear a penalty when paying a dividends.
  - All compensation terms should be dividend-neutral

Paying for Performance (8)

- Be wary of providing incentives to engage in empire-building:

- Bebchuk-Grinstein (2005) show that current executive pay practices provide strong incentives to expand firm size:

  Controlling for past performance, CEOs that have expanded firm size during their preceding years of service are paid substantially more than those who do not.

Conclusion

- There is much that can be done – and should be done – to link pay more closely to performance.