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Reforming executive pay: taking the long view

Executive compensation is an issue that all companies need to take seriously. The 'extortionate' levels of executive pay, seemingly disconnected from performance, have led to public distrust of business. Indeed, Donald Trump's victory in the USA and the UK's Brexit vote were, in part, protests by ordinary people against an out-of-touch elite. Alex Edmans, Professor of Finance at London Business School and Oxera Associate, considers how companies might redesign their compensation strategies not only to increase public trust, but also to create long-term value for shareholders

When it comes to executive pay, before we even think about reform, it is important to study the evidence to see what needs to be reformed—just as diagnosis precedes medical treatment. Indeed, much of the public perception in this area is fuelled by anecdote and myth. This is a particular risk in the case of executive pay, where public sentiment is already high. As such, there is huge potential for 'confirmation bias'—even flimsy 'academic' studies that argue that pay is broken are widely shared and promoted, whereas rigorous studies showing the opposite are not.

Dispelling some basic myths

Before I discuss potential reforms, it is important to dispel the widely held myths. I focus on three.

1. **Chief executive officers (CEOs) are not punished for poor performance**. This myth is promoted by many studies which show that a CEO's salary and bonus change little with performance. Such studies calculate incentives incorrectly because they ignore the substantial incentives that come from a CEO's equity holdings. As a simple example, Steve Jobs was famously paid $1 a year at Apple, regardless of performance. Does this mean he didn't care about performance? Clearly not, because he had hundreds of millions of his own wealth invested in the company's stock. Taking this into account, the median S&P 500 CEO loses $4.8m when the stock price falls by just 10%.[1] Moving to the UK, data shows that this figure is £850,000 for the median FTSE 100 CEO—equivalent to a pre-tax pay cut of £1.5m.[2] It's smaller, but still substantial and, if anything, the comparison might suggest that UK CEOs need more equity compensation, not less, as many claim.

2. **Incentives don't work**, or equivalently, CEOs don't matter. This claim is based on evidence that incentives cause people to focus solely on the measure being incentivised, and ignore other dimensions. For example, a teacher paid according to test scores might ignore extracurricular activities. However, none of this evidence is based on CEOs. CEOs are different because there is a comprehensive measure of performance—the long-run stock price. While the short-term stock price can be manipulated, substantial academic evidence shows that the long-run stock price takes into account not just shareholder value, but other stakeholders. For example, firms that treat their workers well beat their peers by 2–3% per year.[3] Other studies have shown that customer satisfaction[4] and environmental stewardship[5] also affect the long-run stock price. Indeed, the evidence is that firms with high CEO equity ownership outperform those with low CEO equity ownership by 4–10% per year.[6] A separate study shows that shareholder proposals to increase long-term incentives cause improvements in profitability, innovation, and corporate social responsibility (CSR).[7] Note that these studies change CEO incentives only, holding everything else constant, dispelling the myth that incentives don't matter because the CEO is only one of many workers in the organisation.

3. **Fix pay levels to benefit society**. This myth is that the pay level is the most important dimension of CEO compensation to be fixed. And it's easy to see why this myth is popular. The levels simply seem

excessive. The average pay of a FTSE 100 CEO is £5m—more than 100 times that of the average worker.[8] The idea is that the firm is a fixed pie and the only way to increase workers' slice is to reduce the CEO's. But, £5m is only 0.06% of the median firm size of £8bn. In contrast, the value creation from increasing CEO incentives is 4–10% per year. Thus, the structure of pay is more important than its level. The focus should be on expanding the pie, which in turn increases everyone's slice. Rather than bringing CEOs down, any pay reform should incentivise CEOs to bring others up.

Evidence-based reform

So, armed with the evidence, what reforms do I propose?

Grant executives long-term equity

Evidence shows that, when a CEO's equity vests (i.e. the lock-up period preventing sale expires), on average they cut R&D to pump up the short-term stock price;[9] as discussed above, implementing long-term incentives causes higher future profitability, innovation, and CSR. Thus, I propose giving CEOs equity with long vesting periods, perhaps of five to seven years (although one size does not fit all). In particular, the vesting period of equity should extend beyond the CEO's departure. This deters CEOs from inflating the short-term stock price, quitting, and selling their equity before the costs of such short-term behaviour come to light. For example, former Countrywide CEO, Angelo Mozilo, made $129m from selling his shares after he departed, but before the financial crisis which began in 2008.[10] In addition to deterring bad actions, extending vesting periods beyond retirement can encourage good actions, such as succession planning. For example, in his famous book, Good to Great, Jim Collins contrasts 'Level 4 leaders', where the firm is successful only under their tenure, with 'Level 5 leaders', whose influence extends beyond it.[11] In addition, firms should strongly consider giving shares to all employees. Since employees also contribute to the firm's success, they should share in it. This will vastly improve perceptions of pay fairness and boost employee morale—in turn enlarging the pie.

De-emphasise long-term incentive plans (LTIPs)

It is critical to note that long-term equity is very different from LTIPs. These plans pay the CEO according to measures of supposedly long-term performance. For example, a plan may pay out only if earnings per share (EPS) exceed a certain threshold after three years. This leads to short-termism as the end of the performance period approaches—for example, cutting investment to meet the EPS threshold.[12] For similar reasons, I recommend not imposing performance conditions on equity vesting, under which equity vests only if certain financial thresholds are met; otherwise, it is forfeited. Again, evidence shows that CEOs take short-term measures to meet the threshold.[13]

One concern with abandoning performance targets is that CEOs are not adequately punished for failure—they would always receive equity after (say) five years, even if the stock price has fallen. Since equity without performance conditions gives more certainty, and is worth more to the CEO, a firm could accompany the removal of vesting conditions with a reduction in the number of shares, keeping the value of pay constant.

Aside from inducing short-termism, performance targets lead to public distrust, as the actual targets the executive needs to hit are not always transparent. Executives can underperform and yet still be handsomely rewarded, particularly because performance targets are sometimes revised downwards, and the remuneration committee has flexibility regarding which performance metrics to weight. For example, BP CEO, Bob Dudley, was awarded a £14m pay package in 2015, despite the stock price falling by over 15%, and this was fully consistent with the remuneration policy approved in 2014 by 96% of shareholders. This policy set targets on safety and operating performance, which BP met almost fully, and led to the majority of LTIP awards vesting, even though one main reason for this was that the performance targets were subsequently revised downwards due to the oil price change.

Grant executives long-term debt

For example, deferred cash compensation, the value of which is eroded in bankruptcy.[14] Evidence shows that debt-like pay leads to lower bond yields and looser covenants[15]—ultimately benefiting shareholders[16]—as bondholders recognise that a debt-aligned executive is unlikely to take unnecessary risk.

The sum total of these first three measures is that pay will be simple—salary, equity, and debt—unlike the complicated formula-driven bonuses that abound nowadays. These components are also easy to value, and so it is transparent to the public how much the executive will get paid, and under what conditions. These three measures are also advocated by The Purposeful Company, a major project to reform policies in order to encourage companies to pursue long-run purpose rather than short-term profit.[17]

Improve disclosure and transparency

There are several areas of disclosure that can be improved.

- *Hypothetical 'net' pay in addition to gross pay*. This captures the effect that income tax already has in reducing inequality. Indeed, critics often lament the

high level of CEOs' 'take-home' pay, but the amount they actually take home is far less. Of course, the actual net pay will depend on the CEO's own tax position, which we won't know, but applying the national tax rates would give a much better approximation than gross pay.

- *Sensitivity of CEO wealth to performance.* As discussed above, there is a common misperception that CEOs are not punished for poor performance, promoted by studies that ignore the substantial incentives that stem from a CEO's equity holdings. Firms should report CEOs' gains or losses from their equity holdings. There will be large losses in underperforming firms, showing society that CEOs are punished for poor performance.

- *Increase in firm value.* Firms should disclose not only the percentage change in the firm's stock price over the last year(s), but the pound sterling change in firm value, perhaps benchmarked to a peer group. For example, if the stock price rose by 5% in an £8bn firm, this is a rise of £400m. Since CEO pay is a pound sterling number, this allows for an apples-with-apples comparison. Of course, the £400m increase cannot be attributed entirely to the CEO; it may stem from other employees. However, armed with this number, the public can back out what the CEO's contribution must be for pay to be fair. If the CEO's pay is £5m and if it is plausible that they are responsible for 1.25% of the value increase then their pay is fair. Moreover, this disclosure will lead to stakeholders considering the value created by the CEO (pie enlargement) not just the CEO's cost, thus also potentially improving public perception.

- *CEO horizons.* As discussed, it is the horizon of CEO pay, rather than its level, that has greatest effect on shareholder and stakeholder value. One horizon measure is the duration of a CEO's incentives, the average length of time before their different equity holdings vest (analogous to the duration of a bond). Another is to explicitly show the vesting schedule of incentives. For example, a CEO with £1m of equity vesting in one year, and £10m in five years, is likely to have a more long-term outlook than one with the reverse.

Concluding comments

I do not recommend that firms publish or monitor the ratio of CEO pay to median worker pay, as commonly advocated. This ratio does not allow for meaningful comparisons. For example, it is lower in Goldman Sachs than John Lewis, but because bankers are well paid, rather than because bank executives are conservatively paid. Even comparing within an industry is misleading since median pay will depend on the proportion of outsourced and part-time workers (who are likely to be excluded from the ratio), which countries a firm operates in, and the wage costs in these countries, and the mix of capital and labour.

Moreover, such comparisons will tie CEO pay to worker pay and decouple it from performance. Certainly, employee morale is important for long-term firm performance, but pay is only one component of morale; working conditions, on-the-job-training, and opportunities for advancement are also important but ignored by the pay ratios. Indeed, worker pay ignores very many other dimensions of firm performance: stewardship of customers, suppliers, and the environment, as well as profits, growth opportunities, and innovation. The CEO should be paid only if they have created long-term value, and keeping worker pay high is not an excuse for failing to do so. Related to this, a focus on ratios will tie worker pay to CEO pay and thus firm performance, exposing workers to CEO decisions (e.g. a bad merger) outside their control. Workers should be paid fairly regardless of whether the CEO is well paid; a fall in CEO pay (due to poor firm performance) should not lead to a fall in worker pay.

In sum, reform of CEO pay should tie the CEO to long-term firm performance. In the long run, the stock price captures not just shareholder value but also stakeholder value. This will ensure that the CEO increases the size of the pie for the benefit of all.

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Note: The views in this article are those of the author alone.

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[2] PwC (2017), 'Executive Pay in a World of Truthiness'.

[3] Edmans, A. (2011), 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices', *Journal of Financial Economics*, **101**, pp. 621–40; Edmans, A. (2012), 'The Link between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility', *Academy of Management Perspectives*, **26**, pp. 1–19.

[4] Fornell, C., Mithas, S., Morgeson III, F. and Krishnan, M. (2006), 'Customer Satisfaction and Stock Prices: High Returns, Low Risk', *Journal of Marketing*, **70**, pp. 3–14.

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[6] Von Lilienfeld-Toal, U. and Ruenzi, S. (2014), 'CEO Ownership, Stock Market Performance, and Managerial Discretion', *Journal of Finance*, **69**, pp. 1013–50.

[7] Flammer, C. and Bansal, P. (2017), 'Does Long-term Orientation Create Value? Evidence from a Regression Discontinuity', *Strategic Management Journal*, forthcoming.

[8] High Pay Centre, http://highpaycentre.org/.

[9] Edmans, A., Fang, V. and Lewellen, K. (2017), 'Equity Vesting and Investment', *Review of Financial Studies*, forthcoming.

[10] Countrywide, now owned by Bank of America, was a mortgage provider that sold high-risk subprime mortgages.

[11] Collins, J. (2001), *Good to Great: Why Some Companies Make the Leap…and Others Don't*, William Collins.

[12] Bennett, B., Bettis, J., Gopalan, R. and Milbourn, T. (2017), 'Compensation Goals and Firm Performance', *Journal of Financial Economics*, forthcoming.

[13] Ibid.

[14] Edmans, A. and Liu, Q. (2011), 'Inside Debt', *Review of Finance*, **15**, pp. 75–102.

[15] Anantharaman, D., Fang, V. and Gong, G. (2014), 'Inside Debt and the Design of Corporate Debt Contracts', *Management Science*, **60**, pp. 1260–80.

[16] Campbell, T., Galpin, R. and Johnson, S. (2016), 'Optimal Inside Debt Compensation and the Value of Equity and Debt', *Journal of Financial Economics*, **119**, pp. 336–52.

[17] I am a member of the Steering Group of The Purposeful Company.