Executive Pay: What's Right, What's Wrong, and What Could Be Fixed

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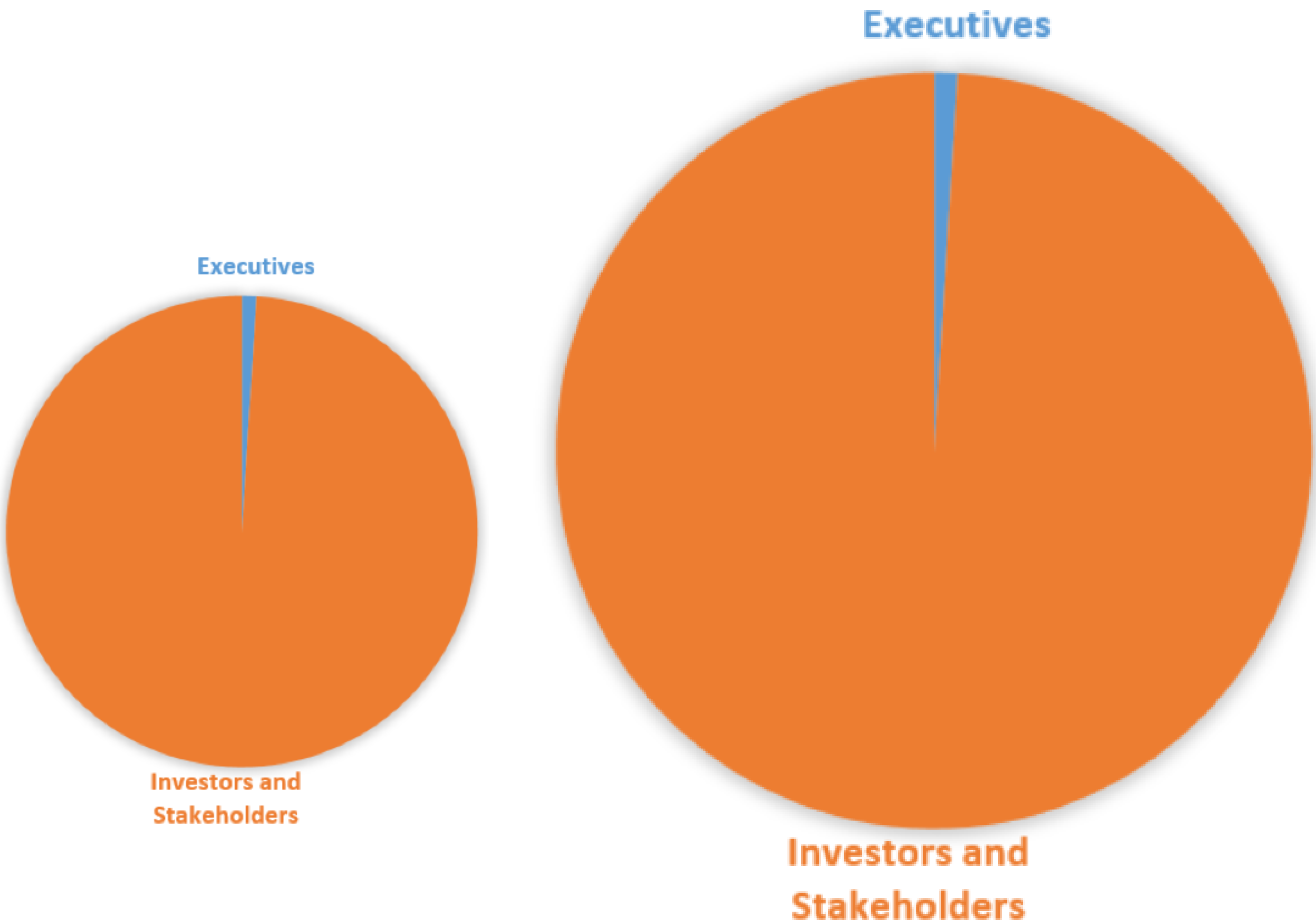
I. The Controversy

The Washington Post

Disney's CEO made 1,424 times as much as his employees. An heir to the Disney fortune thinks that's 'insane.'

- Robert Iger was paid \$66m. Disney market value rose \$75b in prior month
  - \$130 vs. \$24 when Iger became CEO in 2015
  - TSR 578% vs. 140% for S&P 500
- 70,000 jobs created
- Top-quality products[1]
  - Avengers: Endgame had largest-ever North American debut
  - Integrated creative engines of Marvel, Pixar, and Lucasfilm while reviving Disney's studio and theme parks
  - Disney+ subscription has blunted Netflix and Amazon threat
- Iger announced retirement in Feb 2020, stock price fell 2.5% (\$6bn)

1. Sonnenfeld, Jeffrey (2019): "Why Bob Iger Deserves His \$66 Million Pay Package." *Fortune*


Executives
Investors and Stakeholders
Executives
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II. The Approach

An Academic Perspective

- Not the opposite of “practitioner”
- Hallmarks
  - Large scale
  - Rigorous
  - Objective
- Caveats
  - There is lots of bad academic (and practitioner) evidence
  - Evidence can be misused (esp. to support a prior view)
  - See TED talk, “What to Trust in a Post-Truth World”

Beware Confirmation Bias

Caution with Academic Research

- Parliamentary submission: “A second study … found that firm productivity is negatively correlated with pay disparity between top executive and lower level employees”

Journal of Banking & Finance
Volume 37, Issue 8, August 2013, Pages 3258–3272

The determinants and effects of CEO–employee pay ratios ☆

Olubunmi Faleye[a, 1], Ebru Reis[b], Anand Venkateswaran[a, 2]

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http://dx.doi.org/10.1016/j.jbankfin.2013.03.003

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Highlights

- We study the determinants and effects of the relative compensation of top executives and lower-level employees.
- We find that CEO–employee pay ratios depend on the balance of power between the CEO and ordinary employees.
- We find that employees do not perceive higher pay ratios as an inequitable outcome.
- We do not find a negative relation between relative pay and employee productivity.
- We find that firm value and operating performance both increase with relative pay.

Caution with Academic Research

Executive Pay + Add to myFT

UK chief executives earn much more than European peers

Study also fails to find link between higher pay and better performance

- But no-one has ever seen the study

Misattributed Statements

- House of Commons Executive Pay inquiry

the evidence is at best ambiguous on the impact of individual CEOs on company performance.[110]

110 Professor Alex Edmans (CGP0028)

CEOs with high equity incentives outperform CEOs with low equity incentives by 4-10% per year, and the researchers do further tests to suggest that the results are causation rather than correlation

III. The Concerns

Concern 1: High CEO Pay is Unfair

- Mean S&P 500 CEO earned $14.8 million in 2019
  - 264 times the average worker, up from 46 in 1983 (AFL-CIO)
- Median FTSE 100 CEO earned £3.64 million
  - 119 times the average worker
- Hillary Clinton: “There’s something wrong when the average American CEO makes 300 times more than the typical American worker”
- Donald Trump: high CEO pay is “a total and complete joke” and “disgraceful”

CEO Pay is Unfair (cont'd)

- What is fair?
  - Merited by performance, not necessarily equal[1]
  - Cf. exam grades
- Unfairness arises if pay is not linked to performance, or linked to wrong measures of performance
  - Short-term
  - Ignores other stakeholders
- Pay should not be viewed as *compensation* for *effort*, but *reward* for *value creation* (and *accountability* for *failure*)

1. Starmans, Sheskin, and Bloom (2017): Why people prefer unequal societies

Why Has CEO Pay Increased So Much?

- Pay is for talent[1]
  - Compare not to worker pay, but contribution to firm
  - Pay should depend on firm size. CEO effort is scalable: greater effect in larger firms
  - Effort of a rank-and-file employee is not scalable
  - 6x increase in pay justified by 6x increase in firm size
- CEO pay has not risen faster than other highly-paid professions[2]

1. Gabaix and Landier (2008)
2. Kaplan and Rauh (2010)

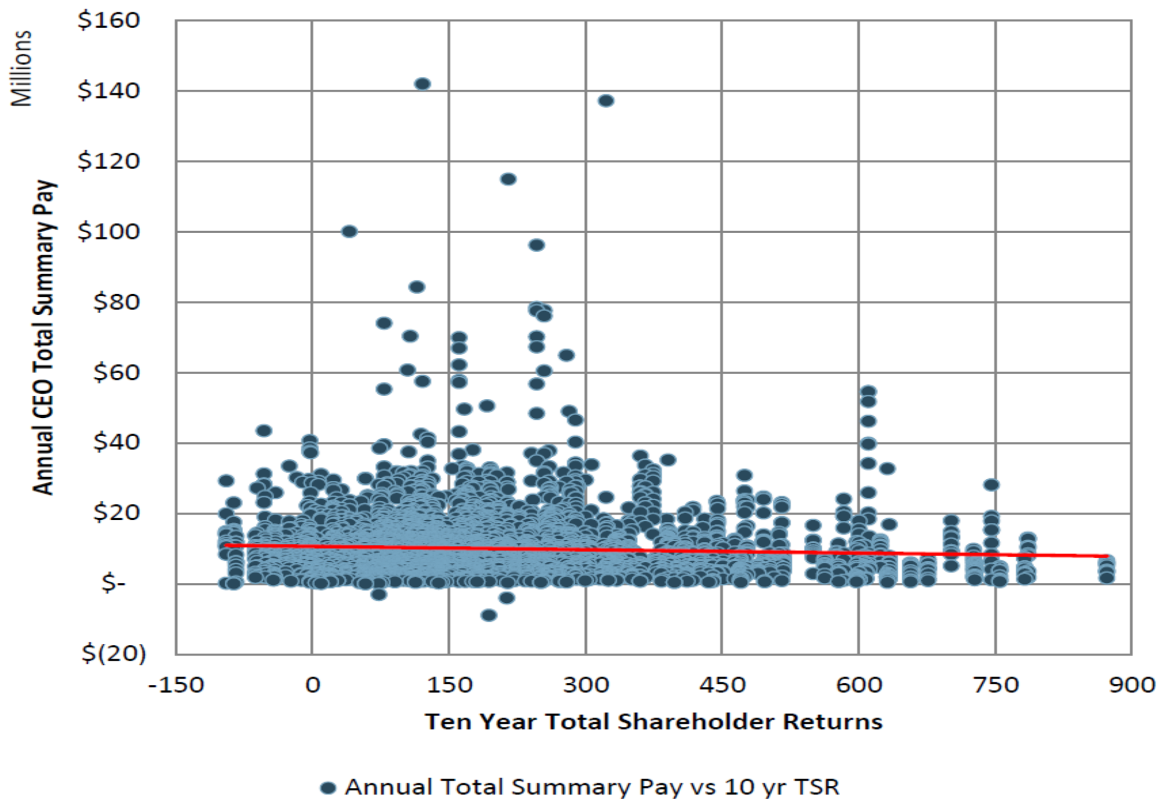
Do CEOs Matter?

- Bob Iger’s departure was voluntary
- Effect of CEO deaths[1]:
  - Reduces stock price by 2%
  - Younger, shorter-tenure CEO: -4%. Young founder: -8.8%
  - Older CEO: +3.6%. Old founder +5.3%
- Deaths of CEO relatives reduces performance

1. Jenter, Matveyev, and Roth (2018)
2. Bennedsen, Perez-Gonzalez and Wolfenzon (2006)

Concern 2: CEOs Aren't Punished For Poor Performance

- MSCI: "Evaluating the Effectiveness of Equity Incentives"



"Companies that awarded their CEOs higher equity incentives had below-median returns"

The Correct Way to Measure Incentives

- Vast majority of incentives come from previously-granted equity
  - *Wealth*-performance sensitivity, not pay-performance sensitivity
- A 10% stock price fall is equivalent to a pay cut of
  - \$6.7m (post-tax), \$10m (pre-tax)
  - £0.8m (post-tax), £1.5m (pre-tax) in the U.K.

Concern 3: Incentives Are Irrelevant / Backfire

- So equity incentives are high. Is this a good thing?
- Incentives don't matter
  - "I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less" (John Cryan, DB)
- Incentives backfire
  - Teachers, doctors. But not for CEOs
- In the long-run, the stock price captures all channels (incl. intangible) through which CEOs affect value
  - Employees (Edmans (2011, 2012))
  - Customers (Fornell et al. (2006))
  - Environment (Derwall et al. (2005))

The Value of Incentives

- High-equity firms beat low-equity firms by 4-10%/year[1]
- Stronger if
  - Low institutional ownership
  - Weak governance
  - Weak product market competition
- Pay CEOs like owners, not bureaucrats. Give them a slice of the pie

1. Von Lilienfeld-Toal and Ruenzi (2014)

IV. The Case For Reform

Issue 1: The Horizon of Pay

- *In the long-run*, the stock price captures all channels (incl. intangible) through which CEOs affect value
- Incentives often have short vesting periods, allowing CEOs to cash out early
  - Countrywide CEO sold $140m of stock in 12m before 8/07

The Importance of Horizons

- Vesting equity causes[1]
  - Cuts in investment (R&D, capital expenditure)
  - Just meeting earnings targets
- Long-term incentives cause[2]
  - Short-run fall, long-run rise in profitability
  - Rise in number, quality, innovativeness of patents
  - Increase in stewardship of employees, environment, customers, society

1. Edmans, Fang, and Lewellen (2017)
2. Flammer and Bansal (2017)

Practical Remedies

- Increase the vesting period of equity
  - 2018 UK Corporate Governance Code increasing minimum from 3 years to 5 years
- Extend vesting period beyond the CEO's departure
  - Encourages succession planning, "Good to Great" thinking (Jim Collins)

Issue 2: The Complexity of Pay

- BP in 2015
  - Biggest loss in history: -$6.5b (vs. $3.8b in 2014)
  - Underlying replacement cost profit (excluding Deepwater Horizon, fall in oil and gas prices) fell from 66c to 32c/share
  - Stock price fell 14%, FTSE All-Share up 24%
  - 5,400 workers lost their jobs
- BP CEO Bob Dudley in 2015
  - Pay rose from $16.4m to $19.6m
  - Includes cash bonus of $1.4m. How calculated?

The Complexity of Dudley's Bonus

2015 annual cash bonus

	Safety			Value					
Measures	Loss of primary containment[a]	Tier 1 process safety events	Recordable injury frequency[b]	Operating cash flow	Underlying replacement cost profit	Net investment (organic)	Corporate and functional costs	Major project delivery	**Total bonus score**
Weight On target Maximum	10% 20%	10% 20%	10% 20%	20% 40%	20% 40%	15% 30%	10% 20%	5% 10%	**100%** **200%**
Weighted outcome %	20	20	20	36	40	30	20	5	**191% = score 1.91**

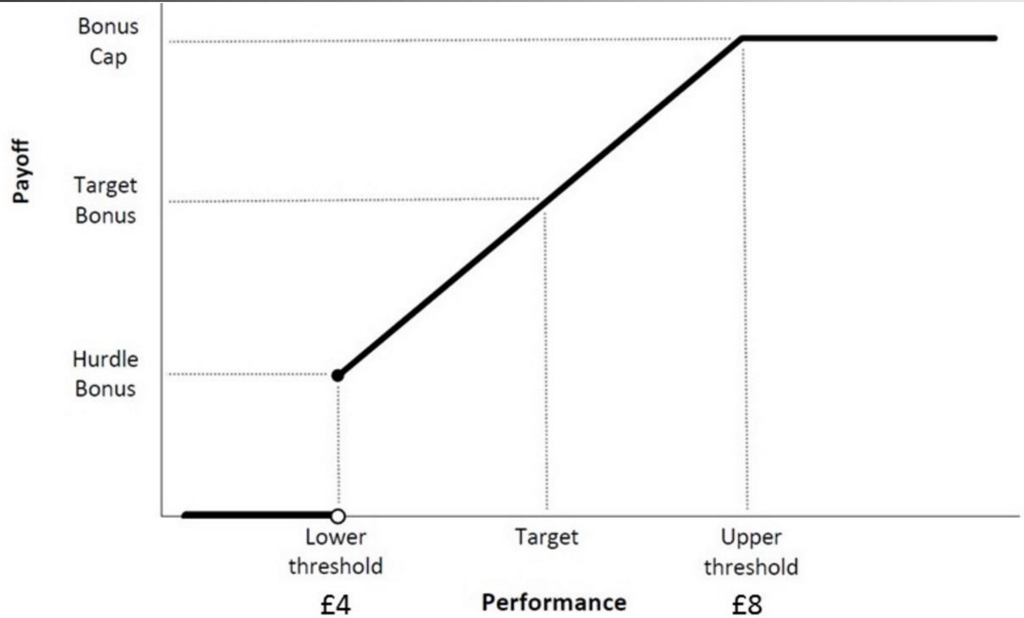
– Target
■ Met
■ Not met
Group key performance indicator

Final score based on committee judgement 1.70

	Loss of primary containment[a]	Tier 1 process safety events	Recordable injury frequency[b]	Operating cash flow	Underlying replacement cost profit	Net investment (organic)	Corporate and functional costs	Major project delivery
Maximum	215 events	20 events	0.235/ 200k hours	$19.7bn	$5.0bn	-24%	11.8% improvement	6 projects
Plan/target	253 events	29 events	0.261/ 200k hours	$17.2bn	$4.2bn	-18%	5.9% improvement	4 projects
Threshold	291 events	38 events	0.287/ 200k hours	$14.7bn	$3.4bn	-7%	No improvement	2 projects
Outcome	208 events	20 events	0.223/ 200k hours	$19.1bn	$5.9bn	-27%	17.6% improvement	4 projects

[a] Adjusted in accordance with the treatment of the LOPC KPI on page 20. Full LOPC is 235.
[b] Recordable injury frequency excludes biofuels.

Bonus Plans



- Bonuses encourage
  - Gaming: close to thresholds[1]
  - Fudging: Ambiguity over choice of performance measures, weightings, targets

1. Bennett et al. (2016)

The Remedy of Simplicity

- Replace bonuses with restricted stock
  - Simple: no need to choose measures, weightings, targets
  - Symmetric: punishes downside as well as rewarding upside; captures almost all measures of performance
  - Sustainable: encourages long-term performance
- Can be given to all employees
- Recommended / implemented by
  - House of Commons Select Committee on Corp Governance
  - Norges Bank Investment Management
  - RBS, Weir Group, Pets at Home, Kingfisher, Hargreaves Lansdown, Mears Group

Issue 3: The Inequality of Pay

- US pay ratio has risen from 46 (1983) to 264 (2018)
- Public *is* angry about CEO pay ratios
  - Even if little effect on pie split, increases inequality
- 2018: mandatory disclosure of pay ratios in UK and US to shame companies into more equal pay

Problems With Pay Ratios

- Not comparable across firms
  - 983 in Wal-Mart, 178 in Goldman Sachs, 393 in JP Morgan
  - 42 in Dunkin' Brands, 1,136 in Chipotle
- May lead to manipulation to improve ratio
- Imply that low ratios are good and high ratios are bad
  - But positively linked to future performance in UK and US
- Decouples CEO pay from long-term performance
  - Suggests a bad CEO is one who is well-paid
- Inequality *within firms* is an ineffective way to tackle inequality *within society*
  - Broad-based solutions, e.g. income tax

V. Conclusion

Conclusion

- Many criticisms of executive pay are based on misperceptions
  - *Ratio* of CEO pay to median employee pay is meaningless
  - *Wealth*-performance sensitivity is incorrectly measured and substantially underestimated
- But areas for improvement do exist
  - Horizon
  - Simplicity
  - Reporting
  - Taxation
- Goal of pay reform should be to grow the pie, not split it differently

Further Reading

- "Grow the Pie: How Great Companies Deliver Both Purpose and Profit"
  - www.growthepie.net contains updates after book was completed