CEO Pay for Performance: The Solution to “Managerial Power”

Ira T. Kay

I. INTRODUCTION

I believe that Pay without Performance by Professors Bebchuk and Fried is an important theory and a book that has some merit. But like many economic and human phenomena, I think that there are numerous factors that influence the CEO pay market; managerial power is only one such factor, and in my opinion, is not the most important factor.

I fundamentally believe, and this belief is supported by a large number of important economists, that the manner in which executives are paid in the United States is a major source of competitive advantage, and we fool with it at our peril. As I have asked a number of institutional investors over the course of the last ten years, “Would you prefer to have the executive pay model, corporate governance, and total returns of Japan, or would you rather have those same factors in the United States?” In other words, would you rather have a package of the low pay, “perfect governance,” and the terrible stock market returns in Japan, or would you rather have ours? I ask the TIAA-CREF people in

* National Director of Compensation Consulting, Watson Wyatt. This paper builds on comments delivered at the Symposium on Bebchuk & Fried’s Pay without Performance, held on October 15, 2004 at Columbia University.


the audience who manage all of your pension funds, “Would you rather have U.S. stocks in your fund or Japanese stocks in there over the last fifteen years?” The answer is obvious. The way U.S. executives are paid has played a tremendous role in creating trillions of dollars in economic value.

I will show you that the way we pay our executives, with tremendous pay for performance, trumps the managerial pay model. I will ask and answer four basic questions: (1) What about the managerial power theory do I agree with? (2) What do I disagree with? (3) Is a high level of CEO “pay for performance” compatible with the managerial power theory? and (4) Does CEO pay for performance exist?

II. WHAT ABOUT THE MANAGERIAL POWER THEORY DO I AGREE WITH?

I first heard about Bebchuk and Fried’s managerial power theory in 2002 when The Economist published an article about a paper they published that year that put forward some of the main ideas developed in their book. This is a very important paper. I agree that the balance of power must and is shifting away from management towards the board. I attend several compensation committees a week (as a subcommittee of the board), and have for the last ten years, which is 1000 to 1500 meetings, and the playing field is clearly shifting from management to the boards. I would argue that, in an agency theory world, the board, which is focused on the company only two days or so a quarter, must give the benefit of the doubt to the management, who is there every day. The board simply does not have full information. But, does that mean that there cannot be things in place that could in fact do a better job of monitoring, signaling, and motivating?

The second thing I agree with is that Supplemental Executive Retirement Plans (SERPs) and deferred compensation clearly need better disclosure. Until two years ago, virtually none of our competitive studies for the compensation committee would have a SERP in it in terms of comparing this executive SERP to their competitors’ SERPs. Now, that is de rigueur, and it is standard that we put into a SERP calculation. I guess we can thank Mr. Grasso for that phenomenon.

I agree with Bebchuk and Fried that there should be more stock ownership and that shares should be held for longer periods of time. We have done research on stock ownership for fifteen years. It was not all that popular during the stock option heyday in the mid-1990s, but companies that have high levels of stock ownership, where the CEOs own significant amounts of stock, dramatically outperform those where they do not own a lot of stock. Finally, I agree that executives should be required to preannounce the sale of their stock.

---

3. Taken for a Ride, THE ECONOMIST, July 13, 2002 (discussing Bebchuk and Fried’s paper).
7. See Table I.
8. BEBCHUCK & FRIED, supra note 1, at 179-83, 191
Table I: CEO Stock Ownership Works!

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>$34.2 million</td>
<td>7.4%</td>
<td>61.1%</td>
</tr>
<tr>
<td>Low</td>
<td>$2.2 million</td>
<td>5.9%</td>
<td>14.1%</td>
</tr>
</tbody>
</table>

Number of observations = 413

III. WHAT ABOUT THE MANAGERIAL POWER THEORY DO I DISAGREE WITH?

I disagree with Bebchuk and Fried’s major point that the fundamental corporate governance and pay model is broken. This is a well researched area in economics with a large literature. By my informal count of the hundreds of articles that I keep in my office, fifty to seventy-five percent of the articles that are in this field show that the labor market is efficient and working pretty well, in many different aspects. Again, Bebchuk and Fried criticize boards for yielding power to management, but I think agency theory would in fact predict that. The more fundamental question is, “Is it working or is it broken?”

I also want to point out—and I have read many, but not all of the articles in their book—that they frequently confuse statistical significance with economic significance. The article by David Yermack, a very important and damaging article to corporate America, says that executives time their stock option grants based upon earnings releases. I attend, as I said, hundreds of meetings and I have never heard that fact discussed. If you read the Yermack article carefully, it is a very small percentage of the thousands of companies that did something that looked fishy, and yes, it yielded statistical significance, but not economic significance.

IV. IS A HIGH LEVEL OF CEO “PAY FOR PERFORMANCE” COMPATIBLE WITH THE MANAGERIAL POWER THEORY? AND DOES CEO PAY FOR PERFORMANCE EXIST?

If high performance yields high pay and low performance yields low pay, and conversely, if low pay yields low performance and high pay yields high performance, is that compatible with a managerial power theory? I posit to you the answer is no. The answer to whether CEO pay for performance exists is yes, and I present you our data on this. Let’s look closely at the answers to this last question, starting with executive stock ownership.

We went back to 1999 for 413 of the 1500 S&P companies where the CEO had been in the job for the same five years. We looked at their 1999 stock ownership and split them into high ownership and low ownership by the overall median. Two hundred

---

10. See Tables II-V.
11. See supra Table I.
seven of the companies had a median ownership of $34 million and the low ownership group had $2 million. We looked at the total returns to shareholders and EPS growth over the subsequent five years. Thus, you cannot say the rising stock price or earnings caused the high ownership since the ownership predates it. This table shows that high CEO stock ownership predates, and most likely causes, high levels of performance.

Table II splits the companies into groups that had an increase in total cash, mostly from bonuses, or groups with a decrease in total cash. You can see that even the low companies that gave a big pay cut (6.3%) still had high Total Returns to Shareholders (TRSs). It ended up that they even had 25% appreciation and dividends, and for whatever reasons, had bad earnings per share, failed to meet budgets and plans, and had to cut their CEOs’ compensation. The data shows executive pay is extremely sensitive to the performance of the company.

<table>
<thead>
<tr>
<th>Percentage Change in CEO Total Cash Compensation</th>
<th>Total Return to Shareholders 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>32.0%</td>
</tr>
<tr>
<td>Low</td>
<td>-6.3%</td>
</tr>
</tbody>
</table>

Number of observations = 994

Table III shows that CEO pay goes down as well as up. In 2002, a typical CEO got $2.7 million in stock options (according to the Black-Scholes valuation method), $600,000 in restricted stock, and $247,000 worth of long-term cash incentives, for a total of $3.6 million. For 2003, stock options plunged and the others increased. The net result was a decrease in executive pay of 16.2%. These executives took a very large cut in their opportunity.

<table>
<thead>
<tr>
<th>Stock Options</th>
<th>Restricted Stock</th>
<th>Cash LTIP</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$2743</td>
<td>$598</td>
<td>$247</td>
</tr>
<tr>
<td>2003</td>
<td>$1853</td>
<td>$839</td>
<td>$317</td>
</tr>
</tbody>
</table>

Percentage Change
-32.5% +20.6% +17.6% -16.2%

Number of observations = 994

Table IV shows that stock option profits increase and decrease as well. Stock prices turned out to be good in 2003, so I split them into high returns to shareholders and lower returns to shareholders, and you see the percentage change of stock option profits. In 2002, these comparable numbers showed that the bottom group took an $8 billion pay cut because their stock option profits disappeared. The pay model is fundamentally working.
Table IV: Stock Option Profits Move with Stock Price

<table>
<thead>
<tr>
<th></th>
<th>Total Return to Shareholders 2003</th>
<th>Percentage Change in Stock Option Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>53.1%</td>
<td>+444.0%</td>
</tr>
<tr>
<td>Low</td>
<td>17.3%</td>
<td>+69.0%</td>
</tr>
</tbody>
</table>

Number of observations = 984

Table V shows that, after the fact, the best paid CEOs worked at the best performing companies. While it is impossible to prove causality—namely that the high pay caused the highest performance—it is also difficult to say that the highest paid CEOs are “not worth it.”

Table V: Actual CEO Pay and Actual Performance

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>$3.2 million</td>
<td>8.7%</td>
<td>13.8%</td>
<td>18.8%</td>
<td>1.3</td>
</tr>
<tr>
<td>Low</td>
<td>$0.8 million</td>
<td>5.3%</td>
<td>7.7%</td>
<td>8.2%</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Number of observations = 999

* Includes profits from exercised stock options

V. CONCLUSION

In terms of my prognosis, stock option usage and stock plan participation will decline. There will be fewer and fewer people getting stock options, which I think will cause cultural, productivity, and economic damage. Executive stock ownership will continue to rise and restricted stock usage will climb. Companies will substitute restricted stock for stock options. Compensation committees will act even more independently. CEO pay will fluctuate, and CEO pay will remain controversial. In conclusion, the Bebchuk and Fried managerial power argument is raising the level of dialogue in boardrooms. Nevertheless, I believe that the executive pay model is working to help the U.S. economy. We need to fix the excesses without breaking the core model.