

Improving Executive Compensation

THE RECENT WAVE OF CORPORATE SCANDALS has drawn attention to the potential costs to shareholders of management serving its own interests. One important area in which there is much room for improvement is executive compensation.

Compensation practices and patterns are not generally the product of arm's-length bargaining between executives and boards seeking to enhance shareholder value. Rather, as we document in recent work, executives have power that enables them to influence the amount and form of their own pay.¹ Some might argue that executive compensation arrangements do not significantly affect shareholders' bottom line and have mainly symbolic importance. There are reasons to believe, however, that such arrangements are of significant practical importance to investors.

First, the amount of compensation dollars paid to executives is not trivial. Between 1992 and 2000, the average annual compensation of CEOs in a widely used 1,500-company database increased fivefold. In 2000, the top five executives of the largest 500 companies in the database received compensation equal to about 4 percent of the firms' combined profits. The percentage was significantly higher for smaller companies. If improved design of compensation arrangements could bring down pay to 1992 levels without adversely affecting incentives, this would by itself produce a measurable increase in corporate profits.

Second, the cost to shareholders from executive pay arrangements that fail to serve shareholder interests is

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more than just the amount of excess pay received by managers. Executives use their influence not only to increase the amount of their compensation, but also to shape it into a form that does not require them to bear much risk nor reduce "managerial slack" (i.e., managers' freedom to depart from shareholder value-maximization). The result is pay arrangements that are not sufficiently sensitive to performance and that do not provide adequate incentives to generate shareholder value. Furthermore, executives have an interest in "camouflaging" the extent to which their pay arrangements do not serve shareholder interests, and this camouflage motive can lead to the adoption of inefficient compensation schemes.

Under current practices, executive pay is decoupled from performance to a greater extent than is commonly recognized. In addition to their salaries, executives receive other substantial benefits that are not tied, or are tied only very loosely, to performance. While salaries are clearly reported in public filings, these other benefits — which include retirement payments, favorable terms on deferred compensation, and, in the past, company loans — are less visible. Furthermore, option compensation is not generally designed to provide the most powerful incentives per dollar spent. Because conventional plans grant executives options to purchase shares at the grant-date stock price, rising markets enable executives



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to realize substantial gains even when their performance is well below that of their peers. Compensation arrangements that are better designed can provide the same or improved managerial incentives with fewer shareholder dollars.

Prevailing compensation practices not only fail to provide cost-effective incentives to serve shareholders but also create some perverse incentives. Executives are commonly given broad freedom to unload vested options and shares. The freedom to unload these positions can lead to substantial distortions in corporate decision making. Executives who are free to unload their shares or options have a weak incentive to undertake efforts whose fruits will not be fully realized in the short run. Such executives also have incentives to bias their decisions in a way that would improve the firm's short-run results at the expense of long-term success. The costs to shareholders of executives' broad freedom to unload their options and shares might well exceed, possibly by a large amount, whatever liquidity or risk-bearing benefits executives obtain from this freedom.

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Institutional investors should work to counter management's influence on its own pay arrangements. Institutions can pressure companies to make compensation more transparent, since transparency will improve outsiders' ability to scrutinize pay arrangements. Institutions should seek arrangements that link pay more tightly to performance and reduce executives' ability to capture substantial benefits when their performance is mediocre. The recent move by companies to use restricted stock grants is a step in the wrong direction, because such grants can provide management with substantial value even when the company's stock price significantly declines. Institutions should also press for restrictions that preclude managers from unwinding equity incentives.

While we have focused on prob-

lems in the setting of compensation arrangements, it is important to note that boards' failure to deal with executives at arm's length on compensation matters indicates the existence of systemic problems in corporate governance. Executive compensation problems arise because under current arrangements boards cannot be relied upon to effectively scrutinize and monitor CEOs' decisions and activities. If this is the case in the context of executive compensation, it is likely to be the case in other contexts as well. For example, boards are unlikely to prevent managers from engaging in empire building or from impeding acquisition offers that would benefit shareholders. Thus, problems in executive compensation highlight the importance of reconsidering existing corporate governance arrangements. ■

To learn more about the research of Professor Bebchuk, go to <http://www.law.harvard.edu/faculty/bebchuk>. To learn more about the research of Professor Fried, go to http://www.law.berkeley.edu/faculty/friedj/homepage_pub.htm.

¹ See Lucian Bebchuk, Jesse Fried, and David Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation," 69 *University of Chicago Law Review* 751-846 (2002); and Lucian Bebchuk and Jesse Fried, "Executive Compensation as an Agency Problem." Both are available at www.law.harvard.edu/faculty/bebchuk.

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