

Executive Pay Today And Tomorrow

by James F. Reda

The challenges boards today face in setting CEO pay have never been greater. Current pay plans have been shaped by a century of compensation trends and fads. Knowing how present CEO pay policies have been shaped (and mis-shaped) by this history is needed as boards reinvent compensation strategy for the new century.

Executive pay packages have exploded over the past six years. With this explosion has come a diverse array of pay alternatives. If done *correctly*, CEO pay can provide a competitive advantage that drives corporate performance to new heights of value. Conversely, if done *incorrectly* it can drive the company to the scrap heap of corporate obscurity.

Corporate boards play a major role in shaping a pay strategy that supports the company's business strategy. Once this is in place you need a dynamic system to measure, monitor and adjust to a changing environment. The result will be the three legs of sustainable competitive advantage.

Adherence to what have been called corporate governance principles is the key. The first leg, one of the most important parts of this mandate, is to get the best people to sit as outside directors on the very important compensation committee. The second leg is full and open communication with the CEO, between each director and in some cases with major shareholders. Third, flexible pay strategies and program, and constant CEO and board evaluations are the glue that holds it all together.

Over 70 percent of the variation in CEO pay is set not by company performance, but by the board's take on corporate strategy, future plans, and current business trends.

Most executive pay consultants will swear that CEO pay is a result of tedious and rigorous regres-

sions. We are here to say that this is not the case. These same executive pay consultants will admit (at least in private) that their regression results are not significant.

Almost 70 percent of the variation of CEO pay was not explained by the performance of the company, the size of the company, the age of the executive, etc. This is only a guide, a starting point. In reality, CEO pay is set by the board taking into account a variety of factors such as the business strategy, current corporate trends, and most importantly where they want to be in the short and long term.

Executive compensation has changed drastically over the past 100 years. The CEO labor market is much more *laissez-faire* than it has ever been. More and more compensation is based on corporate performance, and shareholders are more willing to pay for the best talent. These changes have increased at a geometric rate over the past 10 years. Not only are the levels of compensation increasing at high rates, but also the types of incentive programs are more complex. The task of attracting, retaining and motivating CEOs is more difficult today than ever.

Of the 11,000 publicly traded companies, there are only 800 large capitalized companies, and 1,500 mid-capitalized companies. The remaining 8,700 companies fall into the category of micro-capitalized, and/or emerging companies. In other words, for every IBM there are two mid-sized companies and about 11 small ones.

The uniqueness and importance of each CEO employment arrangement demands a performance contract between the CEO and the company. Each publicly traded company sets a competitive compensation package with its CEO. No two negotiations are the same—therefore no two CEO compen-

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sation packages are the same.

There are approximately twenty economic key points in a CEO package. These range from cash-based elements such as salary, and annual bonus to long-term incentives which are commonly equity-based such as stock options, non-cash perquisites and benefits such as excess medical benefits programs, life-insurance policies, and country-club memberships.

The give and take of the negotiation process ensures a fair deal. This negotiation occurs between the board of directors (in most cases the compensation committee) and the CEO (and his or her advisors.)

Lou Gerstner, chairman and CEO of IBM Corporation, is an excellent example of higher net return to shareholders due to engaging the right CEO at the right time. In 1993 IBM was in a morass. John Akers, the internally developed CEO, did not appear to be doing the job, and the stock price was very low. The board took the unprecedented step of conducting an outside search for its next CEO.

As a result, IBM agreed to pay Lou Gerstner substantial compensation in 1993. At the time, IBM was criticized for over paying. Since that agreement, and in part because of Mr. Gerstner's expert management, negotiation and organization skills, IBM's market capitalization has increased by tens of billions dollars.

The rising importance of institutional shareholders has also increased the general corporate awareness of executive pay best practices. Still, executive pay levels are increasing at an unprecedented rate. Wall Street analysts are becoming more aware of executive compensation practices, primarily in their review of overall corporate governance.

Another related issue is the wider availability of executive compensation information through the SEC's EDGAR project and the increased internet access. This makes executive pay information available to any analyst, investment banker, business school professor or lawyer, and thus places more emphasis on the rationale and basis for CEO compensation.

High-performing companies make performance contracts with their CEO and stick to the agree-

ment—no holidays given and no excuses allowed. Performance contracts are the result of an intensive corporate strategy review where the value drivers are identified and incorporated into the CEO's performance contract.

Demand stretch goals of the CEO, and be prepared to pay whatever is needed to achieve this performance.

Shareholders have been strong advocates of attracting and retaining the right CEO to create shareholder value. An argument has been made that a good CEO compensation package is one in which the CEO pay is a few hundredths of a percent of the increase in shareholder value. This willingness was slow to evolve, but a few dramatic turnarounds have convinced shareholders and investors of the value of executive talent.

The company should demand stretch goals and be prepared to pay whatever is needed to achieve this level of performance. Stretch goals, like those envisioned by Lou Gerstner at IBM and Larry Bossidy at Allied-Signal, are an integral part of a high-performing culture and ultimate success.

How did we come to current level of sophistication in executive pay? The modern era of CEO compensation began in the 1970s, starting with a horrible economy, very few publicly traded companies still being managed by founding family members, and a strong willingness to try new ideas. Compensation plans became complex with the imposition of wage and price controls in the early 1970s and the relatively quick corporate response to find ways around the new government regulation. The "star" CEO was born during this period.

Stagflation and meager stock price performance characterize the "stagnant" 1970s. CEO pay levels increased, on a nominal basis, but were reduced by high levels of inflation. This prompted a steady movement away from the use of stock options. (By 1980, the average face value of annual CEO option grants had dropped to just over one times salary.) A greater emphasis was placed on long-term cash

plans such as performance share and unit plans. Phantom stock plans with a formula stock price emerged from this era.

Another important event in the 1970s was the introduction of the Employee Income Retirement Security Act in 1974 (“ERISA”). This act was introduced in response to lack of pension safeguards that became apparent in the 1960s. ERISA offered favored tax treatment to certain pension benefits. CEO compensation would never be the same again, as such programs as excess pension benefits restoration plans and supplemental executive retirement plans were introduced in response to ERISA.

The 1980s saw the rise of the “star” CEO, as well as the evolution of board compensation committees into a strategic asset.

A bullish stock market and a change in government regulations rekindled an interest in stock options in the 1980s. New legislation lowered the capital gains and ordinary income tax rates. The incentive stock option (ISO) was introduced, and a “golden parachute” excise tax was also introduced in 1984. The net result was that CEO pay skyrocketed, particularly with respect to the long-term incentive component.

One of the most important outcomes of the 1980s is that the “star” CEO system began to emerge. CEOs routinely appeared on the cover of business publications and general media and were inextricably identified with their company and their company’s products.

The “bullish” 1990s provided the crown to the prior ninety years. The economy was in great shape, the stock market rushing ahead, setting continual records. Inflation and unemployment defied conventional economic theory by remaining consistently low and both are at historical lows. (The long-held economic theory entitled the “Philips curve” that held that you could not have low unemployment and low inflation at the same time was reformulated in the face of this extraordinary economic growth.)

Board compensation committees evolved over the

decade as well. They began as a required nuisance evoked by the Securities & Exchange Commission in 1992 and encouraged by the introduction of the \$1 million pay deduction cap in 1993, to become a strategic asset.

Also during the 1990s the economy became global, as worldwide events began to have an immediate impact in the U.S. The internet and the PC revolution dramatically increased the instantaneous flow of information worldwide. Executive pay closely followed the stock market upward.

The resulting CEO performance contracts joined with an unprecedented bull market to trigger huge CEO payouts.

Important factors affecting CEO compensation that clearly emerged in the 1990s include:

□ Information, investment, and service firms, in general, have emerged as the source of U.S. economic growth.

□ Boards of directors (with the consent of shareholders) began to recruit and extraordinarily compensate new executives, especially CEOs, in such a way as to share more of the wealth.

□ The levels of long-term investment opportunity have increased three-fold (as a percentage of salary). We have seen unprecedented levels of merger and acquisition activity over the past six years.

Another important development of the 1990s was that the scrutiny of executive pay increased as various sources began their attack. The public media began to pillory CEOs for high levels of compensation. Congress sprang into action with legislation aimed to stem the tide of increases in executive pay.

The current state of CEO compensation is the result of 100 years of compensation practices. Today:

□ Companies are crafting highly complex and effective performance contracts with CEOs.

□ Companies are very flexible in their approach to CEO compensation and are willing to change for the right business reason.

□ Long-term incentive programs are becoming a much larger part of the total compensation package, causing a shift from different forms of pay and resulting in a more complex package.

□ The accounting, tax and securities rules have become more complex.

□ “Plain vanilla” stock options are being replaced by indexed stock options, performance-vesting options, reload stock options, and EVA-based stock incentive programs.

As we enter the 21st Century, we can offer a list of predictions on the future of executive compensation.

□ *CEO compensation packages will become more standardized on a global basis.* A single worldwide economy will exist, with CEO compensation becoming more standardized. This standardization will also apply to capital markets, accounting practices, shareholders, and other important parties.

□ *Annual cash pay (salary and bonus) will continue to keep pace with inflation.* Although CEO cash compensation (salary and annual bonus) in the short term will continue to increase, it will stay relatively flat in the long term (as it has since the 1930s) when adjusted for inflation.

□ *Long-term incentives will continue to track the stock market.* The level of growth in long-term incentives will closely track the stock market. The types of long-term incentives will also follow the market. In up markets, stock options will prevail and in down markets, cash-based long-term incentives

keyed to corporate performance will prevail.

□ *CEO ownership levels will increase.* CEO ownership, not just pay, will be necessary to retain top talent (reverting back to the early 1900s).

□ *Shareholders will become more active in CEO compensation matters.* Institutional investors will continue to review executive pay practices and director pay practices will receive higher scrutiny. Greater use of shareholder value and pay-for-performance concepts will be seen both overseas and at lower levels of the corporation.

□ *Executive talent will hold its premium value.* Companies will continue to pay higher amounts for executive talents, as there will be greater emphasis on innovation, creativity and relationships of executives.

□ *CEO compensation will be a mainstay of corporate governance.* CEO compensation will be considered the essence of corporate strategy as it becomes more expensive to shareholders and will provide the foundation for long-term corporate strategy. Financial analyst reports will include a section on corporate governance, which will include CEO, and director pay and its implications on shareholder value and long-term corporate strategy. ■

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