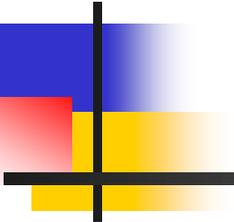


# Executive Pay: What's Right, What's Wrong, and What Could Be Fixed?

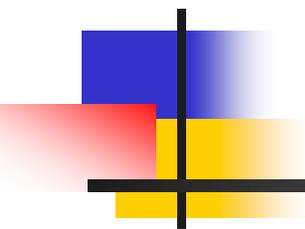


---

Alex Edmans

Mercers School Memorial Professor of Business  
Gresham College

December 2018



# I. The Controversy

---



## Bart Becht's £90m pay packet. I need a lie-down

Pass the Nurofen please. The scale of Bart Becht's pay packet at [Reckitt Benckiser](#) is so shocking it may be necessary to take a lie-down and a couple of his company's bestselling painkillers. Ninety million pounds. For one man, in one year, from a company he does not own. That's £1.7m a week. More than quarter of a million pounds every day. Nearly double the previous FTSE 100 pay record. We've got used to Becht topping the pay charts every year, with huge sums like £36m and £22m. But £90m?



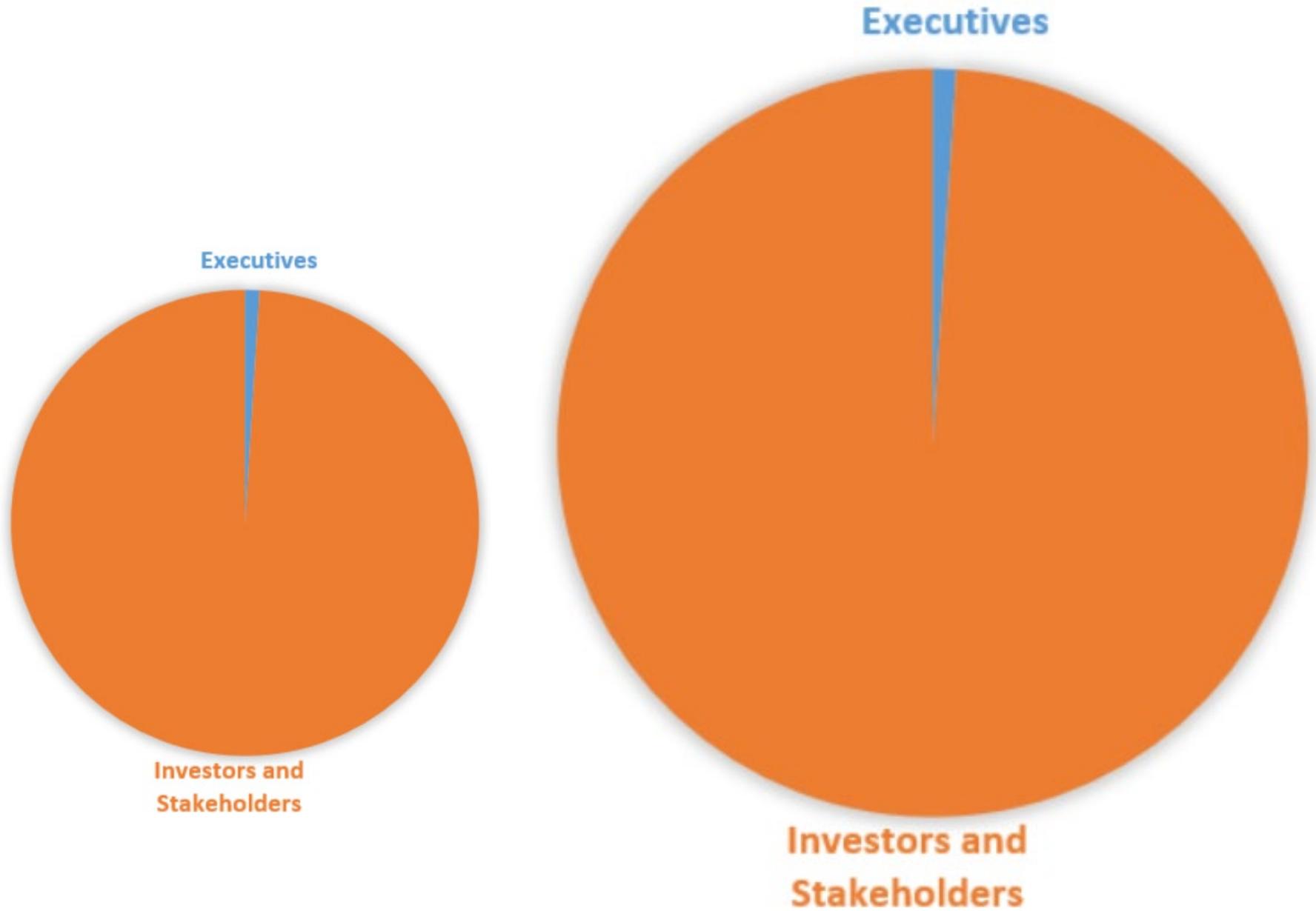
## Reckitt Benckiser shares slump after chief Bart Becht announces retirement

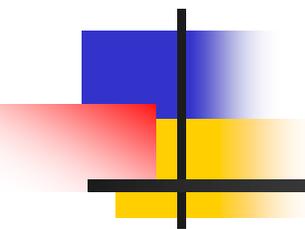
- £92 million pay vs. £1.8 billion loss in market value

<b>Growth in</b>	<b>2007-2011</b>	<b>2012-2016</b>
Revenues	14.0%	0.0%
Operating Income	21.4%	-1.1%
Net Income	21.0%	-0.2%

- £22 billion of value created since 1999 merger (excluding dividends)
  - 4<sup>th</sup>-best performing company in FTSE 100 in past decade

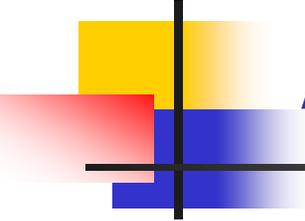
- Customers
  - Reckitt Benckiser widely praised for innovation
  - Customers previously used powder, salt, rinse agent
  - 2000: Finish Powerball 2-in-1 (rinse agent and powder)
  - 2001: Finish 3-in-1 Brilliant (salt)
  - 2005: Finish 4-in-1 (glass protector)
- Employees
  - Headcount grew by 50%
  - Empowerment and flat hierarchy
- Environment
  - Multiple awards
  - Vanish Eco Pack reduced plastic packaging by 70%
  - 2000-11: planted 5.4m trees in Canada; reduced GHG emissions 48%, energy usage by 43%
- Bart gave £110m to charity





## II. The Approach

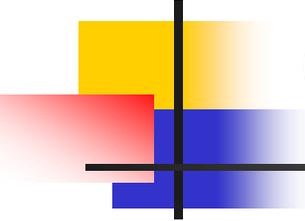
---



# An Academic Perspective

---

- Not the opposite of “practitioner”
- Hallmarks
  - Large scale
  - Rigorous
  - Objective
- Caveats
  - There is lots of bad academic (and practitioner) evidence. See TED talk, “What to Trust in a Post-Truth World”
  - Even if all the evidence I present is correct, it doesn’t mean I’m right. Even if we agree on the facts, we can have different opinions. I invite you to challenge me in the Q&A



# 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”



Dis

## The determinants and effects of CEO–employee pay ratios ☆

Olubunmi Faleye<sup>a, 1</sup>, , Ebru Reis<sup>b</sup>, , , Anand Venkateswaran<sup>a, 2</sup>, 

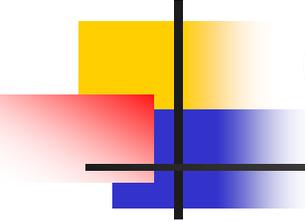
 [Show more](#)

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

[Get rights and conte](#)

### 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

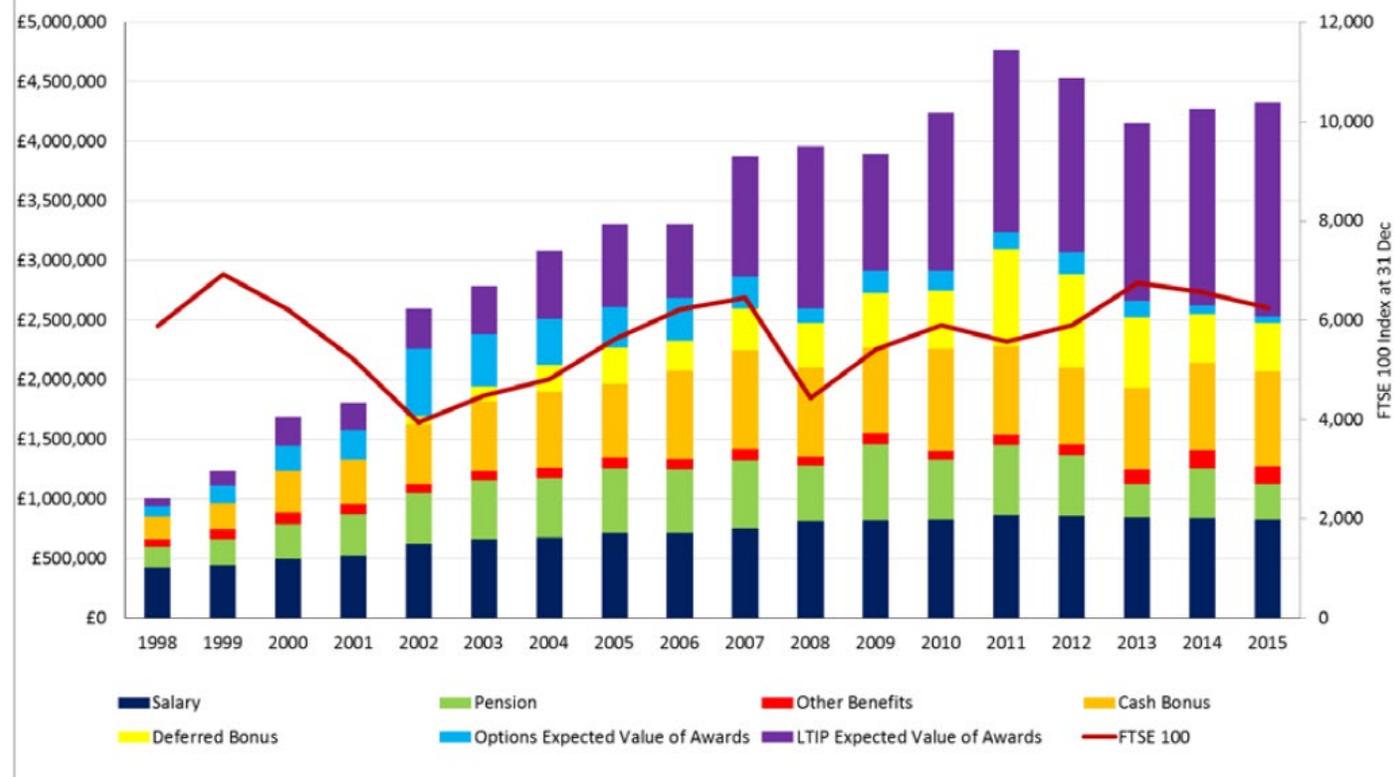
## UK chief executives earn much more than European peers

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

- But no-one has ever seen the study

# Trends in UK CEO Compensation (1998-2015)

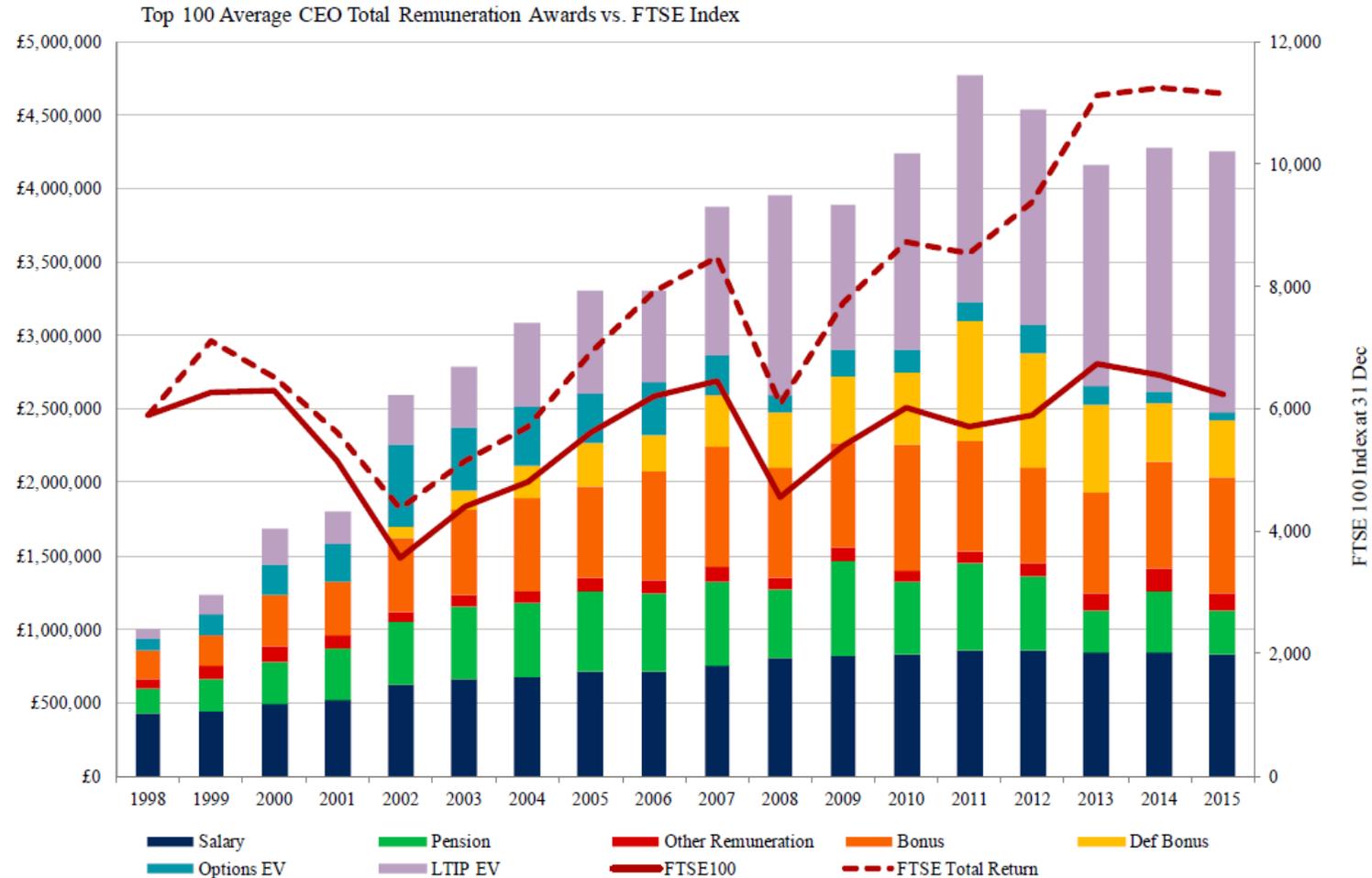
Figure 1: FTSE 100 CEO pay and company values (Manifest Pay & Performance Survey 2015)

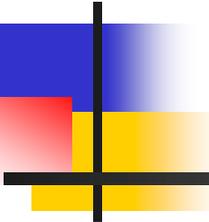


As quoted in the UK Government's Green Paper on Corporate Governance

"CEO pay has quadrupled while the FTSE has been flat"

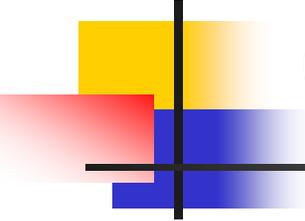
# What They Strategically Omitted ...





## III. The Concerns

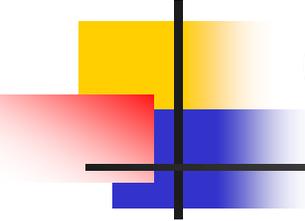
---



# Concern 1: High CEO Pay is Unfair

---

- Mean S&P 500 CEO earned \$13.94 million in 2017
  - 361 times the average worker, up from 46 in 1983 (AFL-CIO)
- 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”

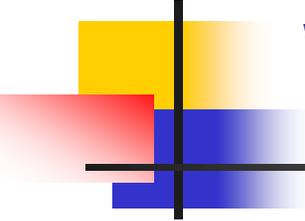


# CEO Pay is Unfair (cont'd)

---

- What is fair?
  - Merited by performance, not necessarily equal<sup>1</sup>
  - 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

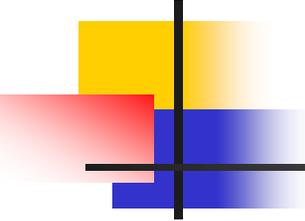


# Why Has CEO Pay Increased So Much?

---

- Pay is for talent<sup>1</sup>
  - 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<sup>2</sup>
- What am I assuming here?

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



# Do CEOs Matter?

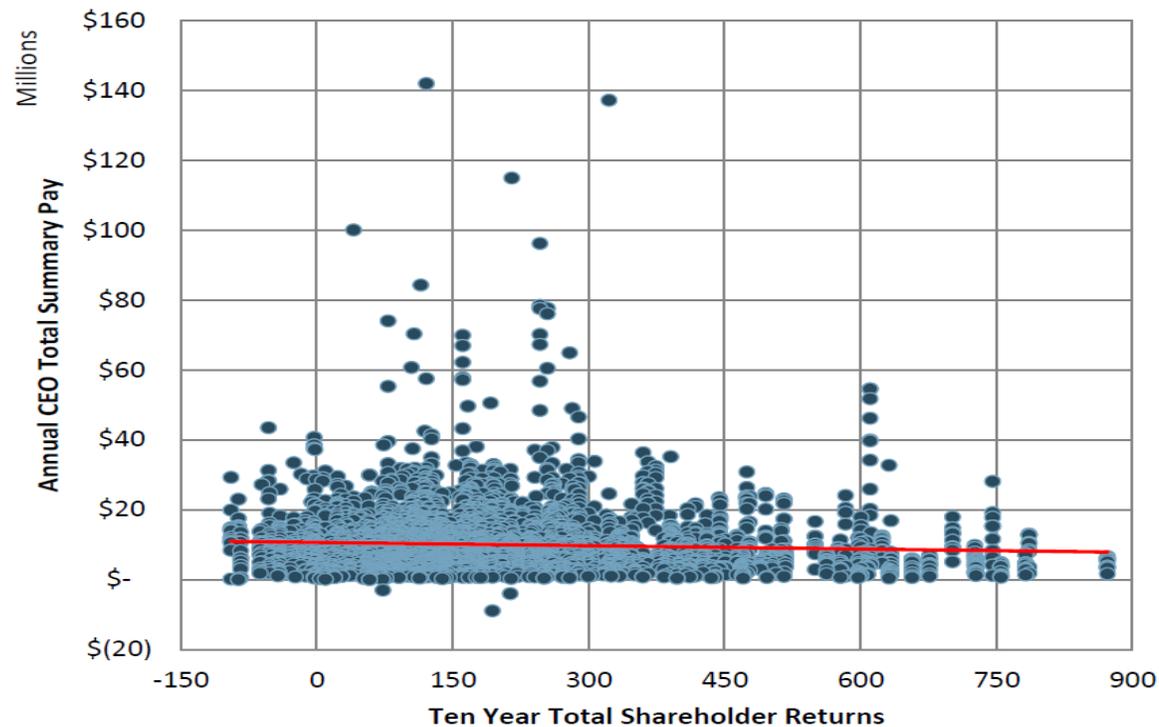
---

- Effect of CEO deaths<sup>1</sup>:
  - 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)

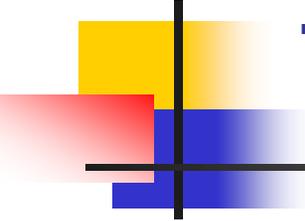
# Concern 2: CEOs Aren't Punished For Poor Performance

- MSCI: "Evaluating the Effectiveness of Equity Incentives"



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

● Annual Total Summary Pay vs 10 yr TSR

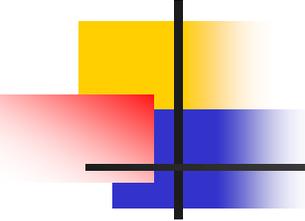


# The Correct Way to Measure Incentives

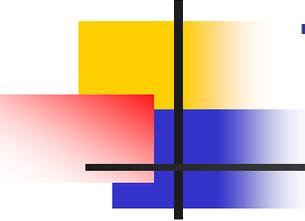
---

- 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



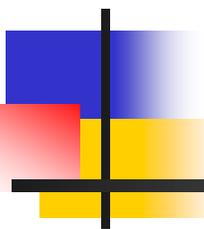
- So equity incentives are high. Is this a good thing?
- Incentives don't matter:
  - "I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less" (John Cryan, 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

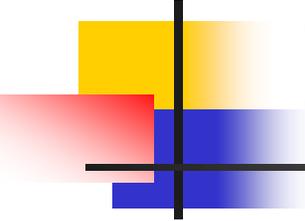
---

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



## IV. The Case For Reform

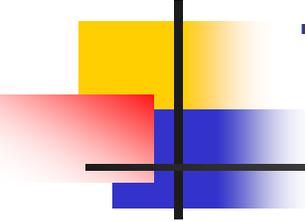
---



# 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 \$129m of stock in 12m before 8/07

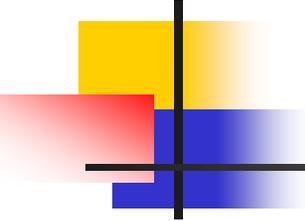


# The Importance of Horizons

---

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

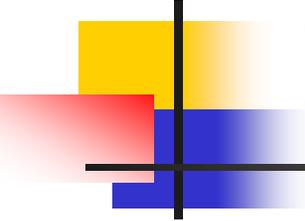
1. Edmans, Fang, and Lewellen (2017)  
2. Flammer and Bansal (2017)



# Practical Remedies

---

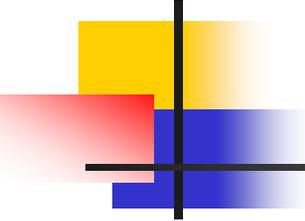
- Increase the vesting period of equity
  - 2018 UK Corporate Governance Code increasing minimum from 3 years to 5 years
- Extend vesting period beyond the CEO's departure
  - Encourages succession planning, "Good to Great" thinking (Jim Collins)



# Issue 2: The Inequality of Pay

---

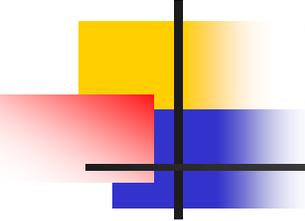
- US pay ratio has risen from 46 (1983) to 361 (2017)
- Public *is* angry about CEO pay ratios
  - Even if little effect on pie split, increases inequality
- 2018: mandatory disclosure of pay ratios in UK and US to shame companies into more equal pay



# Problems With Pay Ratios

---

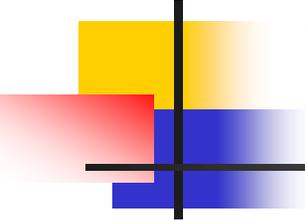
- Not comparable across firms
  - 1,188 in Wal-Mart, 163 in Goldman Sachs, 364 in JP Morgan
  - Higher in Intercontinental than Hilton due to franchising
- May lead to manipulation to improve ratio
- Imply that low ratios are good and high ratios are bad
  - But positively linked to future performance 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



# Issue 3: The Reporting of Pay

---

- Bart Becht's £92m was highly misleading
  - £5m "compensation" for working in 2009
  - £74m from exercising options received since 2001
  - £13m from cashing in shares awarded in 1999 and 2005
- Would have been no spike if Bart had
  - Cashed out early
  - Been paid cash and bought Reckitt Benckiser stock
  - Not delivered stellar performance
- Separately disclose
  - Value at grant date
  - Growth since grant date (may be negative)



# Issue 4: 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?

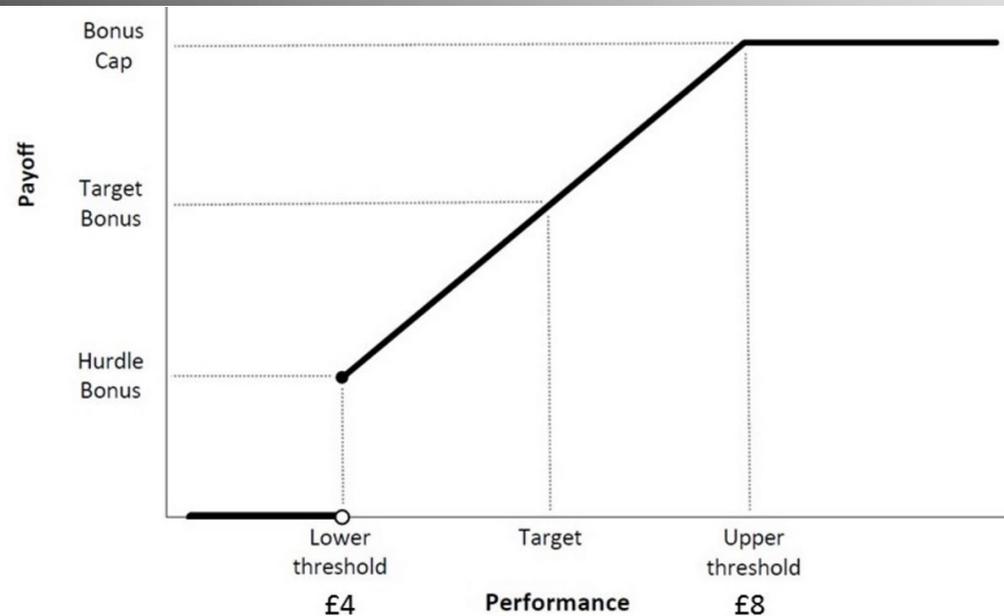
# The Complexity of Dudley's Bonus

2015 annual cash bonus									
Measures	Safety			Value					Total bonus score
	Loss of primary containment <sup>a</sup>	Tier 1 process safety events	Recordable injury frequency <sup>b</sup>	Operating cash flow	Underlying replacement cost profit	Net investment (organic)	Corporate and functional costs	Major project delivery	
<b>Weight</b>									
On target	10%	10%	10%	20%	20%	15%	10%	5%	<b>100%</b>
Maximum	20%	20%	20%	40%	40%	30%	20%	10%	<b>200%</b>
Weighted outcome %	20	20	20	36	40	30	20	5	<b>191% = score 1.91</b>
									<b>Final score based on committee judgement 1.70</b>
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	

<sup>a</sup> Adjusted in accordance with the treatment of the LOPC KPI on page 20. Full LOPC is 235.

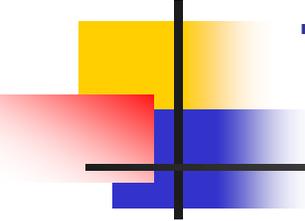
<sup>b</sup> Recordable injury frequency excludes biofuels.

# Bonus Plans



- Bonuses encourage
  - Gaming: close to thresholds<sup>1</sup>
  - Fudging: Ambiguity over choice of performance measures, weightings, targets

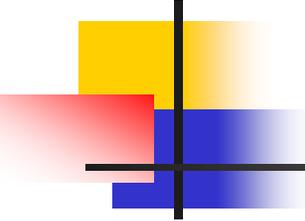
1. Bennett et al. (2016)



# The Remedy of Simplicity

---

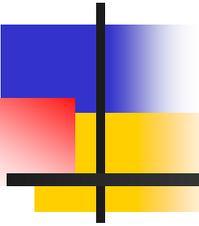
- Replace bonuses with restricted stock
  - Simple: no need to choose measures, weightings, targets
  - Symmetric: punishes downside as well as rewarding upside; captures almost all measures of performance
  - Sustainable: encourages long-term performance
- Can be given to all employees
- Recommended / 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



# Potential Concerns

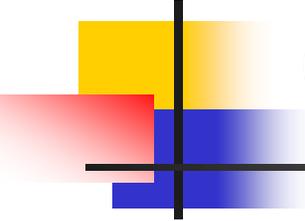
---

- Advantage of bonuses is that it's clear what a CEO should do to get paid
- Leads to greed – CEOs work hard only because it makes them rich
- Removal of performance thresholds makes pay *less* sensitive to performance



# 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