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The Crystal Report on Executive Compensation

The Bureaucrats Take Over

by Graef Crystal

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On Oct. 20, the U.S. Treasury issued regulations covering executive compensation in financial firms receiving government aid.

Upon reading this document, my initial reaction was -- and still is – you've got to be kidding.

In an article I published in September, entitled: "Dear Nancy and Barney: You've Been Had", I noted some ominous, as well as enigmatic, language in the executive compensation legislation that emphasized "limits on compensation that exclude incentives for executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary [of the Treasury] holds an equity position in the financial institution."

I advised readers at that time to "Stay tuned".

The New Treasury Rules

Well, here we are. In essence, the Treasury Department has decreed that:

- Within 90 days of the monetary injection from the Treasury, the board's compensation committee must review compensation arrangments for the five executive officers on the company's proxy statement with that institution's "senior risk officers or other personnel acting in a similar capacity, to ensure that the SEO [i.e., the Top Five] incentive compensation arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution."

- This review process must occur at least annually.

- The compensation committee must certify that it has completed the necessary reviews. Here's an example of what the Treasury has in mind: "The compensation committee certifies that it has reviewed with senior risk officers the SEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not **encourage** [emphasis is mine] SEOs to take unnecessary and excessive risks that threaten the value of the financial institution."

I have three questions here:

- Until I read the Treasury regulations, I had no idea that the position of senior risk officer even existed. But at a faculty dinner at Berkeley last week, I was told by a colleague that the position does exist, at least in the Wall Street firms. The person holding that position is charged with reviewing the risk profile of the company and advising the CEO on such issues. The question: Where in the world was that senior risk officer when the companies were going down the tubes due to – excessive risk-taking?

- To whom does the senior risk officer report. If the person is an officer of the company, that must mean he's an employee of the company. And that, in turn, means he reports to the CEO of the company or lower down in the management hierarchy. But, of course, he cannot be one of the Top Five, because that would pose a conflict-of-interest. So how objective do you expect this person to be when he is passing judgment on his bosses' pay arrangements?

- Finally, where is the bright line between an incentive that is OK and one that "encourage[s] SEOs to take unnecessary and excessive risks".

Fred Cook Link

Fred Cook, with whom I worked at Towers Perrin in the early 1970s, and then had the guts to go out and found his firm, Frederic W. Cook & Co., in the middle of a recession, is, so far as I am concerned, the top pay consultant working in America today.

He recently published an essay to which readers of this article may link. (To do this, please go back to the "Articles" page of my website, and you will find the link immediately preceding the link to this article.) In his essay, Fred gamely attempts to illustrate the sorts of incentives that he thinks could fall in the "no-no" category. I do not agree with everything he says. But he is the first expert I know who has even made a stab at trying to aid utterly confused compensation committees. And he should be applauded for it.

Extremely-Risky Pay Packages

At the outer limits, it's not too difficult to cite a pay package as being in that no-no category. For example, take the early pay arrangements of Richard Fairbank, the CEO of Capital One Financial Corp:

- No base salary.
- No annual bonus.
- No benefits.
- Just huge option grants. Although the strike prices of the options were equal to the market price at grant, the option was cancelled unless the stock price rose by at least 73 percent within three years of the grant date (i.e., at an anualized rate of 20 percent a year over the three-year period).

Now we could tweak Mr. Fairbanks' package to make it even more unappealing to the people administering the new Treasury regulations:

- Give that option a strike price that was three times the market price at grant.
- Make the option exerciseable from day one.

But as we get closer to normality, where is that bright line?

Take Michael Eisner's 1996 pay package (which I had a hand in designing):

- He had a base salary of $750,000, which was frozen for years.
- He could and did receive annual bonuses in the millions.
- He was given a four-tranche stock option in 1996 covering a split-adjusted 24 million shares:
  - Nine million carried at-the-market strike prices.
  - Three million carried a strike price that was 25 percent higher than the market price at grant.
  - Three million carried a strike price that was 50 percent higher than the market price at grant.
  - Three million carried a strike price that was 100 percent higher than the market price at grant.

Does that pay package, with its huge option grant and out-of-the-money strike prices, qualify as excessively risky. Who knows?

Now What?

So what will happen? Given that the comp committees must certify that they believe they are doing the right thing, I figure they will head for the trenches and err on the side of too little pay risk.

One thing the Wall Street firms' compensation committees will likely do is to raise base salaries. For 2007, CEO base salaries ranged from $250,000 at Bear Stearns Companies Inc. to $800,000 at Morgan Stanley, with a median of $600,000, which turned out to be the salary of Lloyd Blankfein, the CEO of The Goldman Sachs Group Inc. These salary levels are much smaller than those at comparably-sized non-Wall Street firms. Raising base salaries cannot conceivably be considered "risky". Once the base salaries are raised, bonuses can be slashed by a like amount or, one would hope, by a greater amount (which would recognize that bonuses are a more risky form of compensation than base salaries.)

Of course, that's small potatoes for the Wall Street firms, which are accustomed to paying bonuses in the scores of millions. If all the critics out there are to be satisfied, those bonuses will have to be substantially reduced and not just in bad years.

But the underlying premise of Mr. Paulson and Speaker Pelosi and Rep. Frank, and their ilk, is that money motivates. That I would kill your mother for five bucks and my own mother for 10 bucks.

Translating the above for the Wall Street crowd, who are noted for their watermelon-sized greed glands: I would kill your mother for a quarter and mine for half-a-buck.

Does Money Really Motivate Top Executives?

I wonder, though, whether this premise is unduly simplistic.

It is certainly the case that a person working at a McDonald's may have to take a second job to put bread on the table for his spouse and babies.

But the people we are talking about don't have any babies – not now they don't. And they are, for the most part, already quite wealthy. And they are not in the acqusitive phase of their lives, having to buy washing machines and furniture.

So it requires extrapolation to reason that just because the McDonald's worker is motivated by money, so is a person whose net worth is $100 million and who has been earning $30 million a year. Will he respond to even a risky incentive if he is already working as hard as he can and as smart as he can?

As a test of how much monetary motivation sways executive decisions and performance, I re-visited a database I had earlier constructed showing option grants made to major-company CEOs in 1999.

There were 1,059 grants in my database. I finally focused on eight grants that met the following two criteria:

- They were extremely large. The smallest grant covered $34 million of stock (i.e., the product of the number of shares in the grant and the market price at grant was $34 million). The largest was $132 million. And the median was $51 million. And remember, that was way back in 1999.
- The CEOs who received them are still on the job.

I then calculated for each CEO the company's shareholder return during the period beginning with the date of grant and ending this Nov. 14. (One exception: The grant made to John Chambers of Cisco Systems Inc., which carried a nine-year term, expired on April 16, 2008. So I used that as the end date for measurement of shareholder return.)

Then I compared the shareholder return figure for each company to that for the Standard & Poors 500 Index for the same period. By subtracting the S&P 500 return from the company's return, I derived the so-called "excess return".

The median excess return among the eight companies was negative 2.1 percent a year. The returns ranged from negative 15 percent a year for Armonk, New York-headquartered insurance company MBIA Inc. to positive 26 percent a year for San Francisco-headquartered biotech firm Genentech Inc. Five of the eight firms had negative excess returns.

Now these findings come with three caveats:

- These grants were not the only grants these CEOs received since 1999. The adage "one swallow does not a summer make" needs to be kept in mind.
- I have assumed (except in the case of Cisco's John Chambers) that the option was still outstanding as of Nov. 14. That may or may not be true.
- Eight cases are not very many.

All that said, though, if money motivates, you might of thought that the median excess return would have been substantially positive. That it was not is certainly food for thought.

You Take Government Aid. Then Government Calls the Tune

Granted that if a company gets money from the government, it is going to have to endure some interference from the government. But what the Treasury has done is to create a bureaucratic nightmare.

Consider a similar and even greater nightmare created by Richard Nixon, who, improbably for a Republican, imposed pay controls on the entire U.S. economy in the early 1970s. He did it to try and bring the then inflation under control. Under the Nixonian pay controls, no one could receive a pay increase -- if I recall correctly – of more than five percent a year.

But then the issue of promotions came up. The government bureaucrats had to write all sorts of regulations to define just what a promotion really was and how much of an increase could be granted. That allowed for much gaming of the system by pay consultants.

But in any event, the company across the street could lure your employees away and give them anything they wanted coming in. Of course, once they were in, their pay was limited to an increase of five percent a year. Then, after a decent interval, you could hire them back and pay them even more.

When the controls ended, pay surged. But in the meantime, there were all sorts of economic dislocations.

My own take: The government shouldn't be bailing out companies, and it shouldn't be meddling with executive pay, either. But we're beyond that, unfortunately.

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.