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How to Fix Executive Compensation

For starters, don't link pay packages just to stock. Tie them to debt as well.

By ALEX EDMANS

The secret to reforming compensation isn't so much looking at how *much* bosses get paid—but *how* they get paid.

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It's easy to understand why critics focus on the gaudy awards of cash and stock that executives take home. And, yes, it's hard to deny that some bosses get paid a lot more than they deserve. But the *structure* of compensation is ultimately a lot more important than its level, because it gets to the heart of how managers run companies and create value for shareholders.

Pay packages should give managers strong incentives to run companies correctly, to make them think in the long term and avoid taking excessive and potentially destructive risks. In many cases, they are well-designed and provide CEOs with the correct motivation. But in others, pay packages not only fail to achieve that goal but push executives in the other direction.

There are creative ways—yet simple and easy to implement—to tie executives' fortunes to the long-term health of their companies. Tying bosses' pay to the levels of debt at the business, for instance, will dissuade them from taking risks that might alienate creditors. Preventing executives from selling company stock until several years after it's granted will give them a powerful incentive to think long term. And updating the compensation package to reflect changing conditions in the market and the company will ensure that managers' interests are always aligned with those of the company and its shareholders.

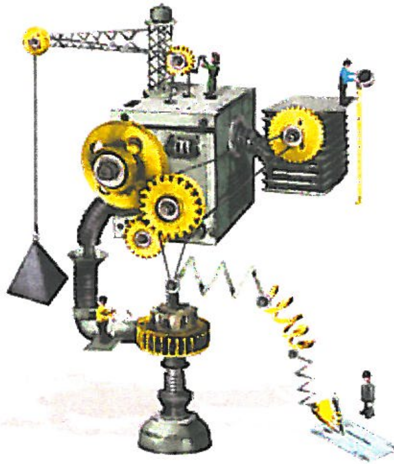
Here's a closer look at those proposals.

Pay Them in Debt

An effective way to deter executives from taking excessive risk is to compensate them with debt-based pay as well as equity. However, many compensation packages feature only cash and equity.

Consider what happens when a boss who gets paid only in stock is facing a big choice that affects debtholders.

Let's say the company has $1 billion in debt but assets of just $900 million. If the CEO liquidates the business, debtholders get 90 cents on the dollar, but equity holders (like the CEO) are wiped out. Obviously, that's not an attractive prospect for the boss.



Richard Borge

Now imagine that the CEO has before him a proposal that has an equal chance of gaining $200 million and losing $400 million. Clearly, the project is undesirable from a company-value perspective. However, since the manager holds *only* equity, he has little to lose by taking it. Stockholders are going to get wiped out anyway, so they're not going to lose more if the move fails. But if it succeeds, the company is worth $1.1 billion—and equity holders have $100 million to share, after the debtholders get paid off.

Looking at things from the debtholders' point of view, though, the move is clearly undesirable. If the boss doesn't take on the plan, they recover 90% of their money. If the boss goes through with it and succeeds, they get an additional 10% back. But if the strategy fails, they collect just 50% total.

Boards of directors, who design pay packages, are elected by shareholders. So, why should they care about debtholders at all? Because if potential lenders expect the CEO to take such gambles, they will demand a high interest rate and restrictive covenants, ultimately costing shareholders. A high interest rate cuts into profits, and restrictive covenants may prevent managers from undertaking desirable investment.

Qi Liu of Wharton and I have shown that the optimal pay package involves giving managers debt-based compensation as well as equity. Contrary to intuition, the CEO's optimal equity/debt ratio typically differs from the company's. If the business is financed with, say, 60% equity and 40% debt, it may be best to give the CEO 80% equity and 20% debt-based pay. The optimal debt ratio for the CEO is usually lower than the company's, because equity is typically more effective at inducing effort. However, the optimal debt ratio is still nonzero—the CEO should be given *some* debt compensation.

As for what *kind* of debt to give as compensation, it can take any number of forms. First, defined-benefit pensions and deferred compensation are already frequently used in practice. These instruments have equal priority with other unsecured creditors in bankruptcy, giving the CEO a strong incentive to look after their interests. And they seem to work: The research of Raghu Sundaram and David Yermack of New York University finds that CEOs with large defined-benefit pensions manage their companies more conservatively. Similarly, a paper by Divya Anantharaman and Vivian Fang of Rutgers University and Guojin Gong of Pennsylvania State University finds that debt compensation leads to fewer loan covenants and a lower cost of debt.

Second, compensation can be explicitly tied to debt values. American International Group Inc. used that kind of system in 2010, before its recapitalization, for certain elements of compensation for highly paid employees. In that plan, 80% of the pay was tied to the price of some of the company's bonds, and 20% was tied to the price of its stock. Third, the CEO can be granted actual debt securities such as corporate bonds, just as CEOs typically hold stock and options.

Make Them Wait to Cash In

Another critical change companies should implement is to lengthen the time that executives must wait before they can cash in their shares and options. All too often, stock and options have short vesting periods, sometimes as little as two to three years. This encourages managers to pump up the short-term stock price at the expense of long-run value, since they can sell their holdings before a decline occurs. A CEO can, for instance, write subprime loans to boost short-term revenue and leave before the loans become delinquent, or scrap investment in R&D. This is possible since, in many cases, stock and options immediately vest when the CEO leaves the company.

In a paper with Xavier Gabaix and Tomasz Sadzik of New York University and Yuliy Sannikov of Princeton, we show that optimal compensation packages involve long vesting periods. In particular, the pay packages don't vest more quickly when a CEO leaves a company—the executive must still wait several years before cashing in.

Three Steps To Smarter Pay

How a package is structured is more important than how big it is, says Prof. Alex Edmans of the Wharton School. His recommendations:

1. Don't Ignore Debt
Base the CEO's pay on the performance of both the company's debt and its stock. This discourages excessive risk taking—and an incentive to pump up the company stock—by aligning management's interests with creditors instead of just shareholders.

2. Think Long
Extend the vesting period until after the CEO leaves the company. That encourages the CEO to think long term, and eliminates the temptation to make destructive short-term moves that temporarily lift the stock price.

3. Be Flexible
Change the structure of the compensation package as circumstances change. So, for instance, the CEO gets more stock and less cash after company shares plummet, restoring the CEO's incentives to boost the long-term share price.

Source: Alex Edmans
The Wall Street Journal

Just how long should a CEO wait? It depends on the kind of company. The waiting period should be longer in businesses where the CEO can take actions with very long-term consequences. It might be seven years or more at a drug company with a lengthy product pipeline. But the wait might be shorter at, say, a commodity chemical company, where CEO decisions usually don't have an impact more than a few years ahead.

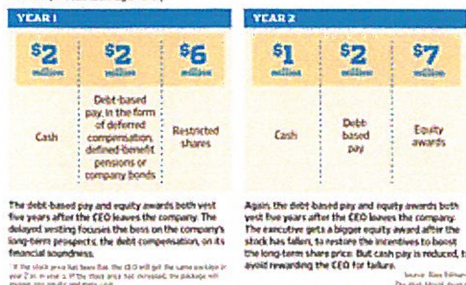
Of course, there is a trade-off. If companies make CEOs wait *too* long to collect, the former bosses might be exposed to risks outside their control, such as regulatory changes that eat into profits. Companies need to find a balance that works best for their situation.

Change to Fit the Times

Even a compensation plan that's well-designed at the outset can fail to keep pace with the market and the company's fortunes. Take the case of a corporation that pays its boss in stock options. If the company hits a rough patch and its shares plummet, an executive's stock options become close to worthless and lose much of their incentive effect. This problem may still exist even if the executive has all stock and no options.

Let's say the CEO is paid $4 million in deferred cash and $6 million in restricted stock. At the outset, boosting the value of the company by, say, 1% is worth $60,000 to him—a good inducement to put in more effort or drop a costly pet project. But if the share price halves, his restricted stock is now $3 million. So, this incentive is slashed to $30,000.

To maintain the power of the incentives, the CEO must be required to hold *more* stock after a stock-price decline. How much more? In the paper with Profs. Gabaix, Sadzik and Sannikov, we show that the CEO's stock should remain a roughly constant percentage of compensation.



In the example above, this target was 60%. At the start of the CEO's contract, that meant $6 million out of $10 million total compensation. We call this the CEO's "incentive account." Now that the stock has halved, the incentive account is worth only $7 million—$4 million in cash and $3 million in stock. To keep the equity level at 60%, the CEO must have $4.2 million of stock. This is achieved by rebalancing the CEO's incentive account: exchanging $1.2 million of cash for stock, so that the executive now has $2.8 million of deferred cash.

Since the additional stock is accompanied by a reduction in cash, it isn't given free. This addresses a major concern with the repricing of stock options after company value falls: Repricing rewards the CEO for failure by giving him a lower stock-price target to reach. Note that, even if the board is reluctant to amend the terms of previously awarded compensation by exchanging existing stock for cash, the desired rebalancing can still be easily implemented; next year, the board simply pays the CEO more equity and less cash.

If companies employ the three above principles—debt-based compensation to reduce risk, long vesting periods to dissuade short-termism and rebalancing to ensure incentives at all times—executives will be aligned with the long-term health of their companies. And that will not only help keep individual companies safe, it will reduce the risk of another financial crisis.

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