Event Report: ‘Market or Racket: do we need a new approach to executive pay?’

Reflections on pay and performance

Steve Kaplan, Neubauer Family Distinguished Service Professor of Entrepreneurship and Finance, University of Chicago Booth School of Business

Steve Kaplan gave the closing keynote.

Kaplan began by telling the audience that there are three common perceptions of CEO pay and corporate governance in the US. These are that CEOs are overpaid and their pay keeps increasing, that CEOs are not paid for performance, and that boards do not penalise CEOs for poor performance. He said the real key question is whether CEO pay and governance is driven by the power of CEOs over their board, a view that Professor Dirk Jenter had earlier referred to as the ‘camp one’ view that executives are stealing from shareholders, or whether it is a competitive market for managerial talent with CEOs being paid appropriately, which Jenter had referred to as ‘camp two.’ Kaplan said that his own views fit into camp two.

Kaplan set out two ways to look at pay; the grant date or estimated pay at the time the board gives it to the CEO, and realised pay which is what CEOs actually receive. He said the former is more relevant for evaluating what boards are doing and the latter more relevant for evaluating pay for performance. Kaplan presented data to show that the widely held belief that CEO pay has surged is not represented in the data. He showed the audience what has happened to average S&P 500 CEO pay since 2000, in millions of 2018$. He said people may be surprised to see that the average in real terms has come way down, down by around 30% and the median has been flat since around 2001. According to the data, the median and average are around $10 or 15 million and Kaplan pointed out that the average being very close to the median indicates that the outliers have gone away. He showed how average realised pay has been flat and moved largely in line with the stock market, indicating there is pay for performance. The number of public companies has gone down over time, but those that remain public have got bigger. As a result, CEO pay to profit before tax of S&P 500 companies is the lowest it has been in 25 years. He said ‘camp one’ would therefore conclude that relative to earnings CEO pay is getting less and is too low. He said the level of CEO pay to the average worker is of course still very high. Relative to median household income, executive pay is higher by a ratio of around 200 times. Kaplan explained that this contributes to the perception that CEOs are overpaid.

Kaplan said it is important to take into account higher levels of CEO turnover, which could indicate that the CEO role is less safe than years ago. He said that CEO turnover levels have increased from 13% per year at Fortune 500 firms between 1992 and 1997 to 16% per year between 1998 and 2010, which may show that CEOs’ jobs are more at risk today versus 20 years ago. Kaplan said this is consistent with data from PwC showing that CEO turnover in US companies since 2000 has been just under 14% a year. The average life of a CEO is around seven years versus nine or ten years two or three decades ago.

To examine whether CEOs are overpaid, Kaplan compared CEO pay to other professions in the top 0.1%, such as consultants, law partners, private equity investors and entrepreneurs. Kaplan found all of these professions have enjoyed rising pay, suggesting a general trend rather than a racket in the CEO market in particular. Kaplan referred to a study by Smith, Yagan, Zidar and Zwick which concluded that entrepreneurial owner-managers played a leading role in driving top inequality in the US since 2000. Regularly 20 hedge fund investors make more money than all 500 S&P 500 CEOs, and private equity partners (who are often former CEOs) often make $5 - 20 million a year. Kaplan said
the fact that so many private company executives, with fewer agency problems, have seen their compensation increase by more or at least as much as public company executives, suggests the market for talent has played the most important role in CEO pay increases and is the reason why he is firmly in 'camp two.'

Technological change and greater scale have increased the returns and productivity at the top end, Kaplan asserted. Innovation in information technology has enabled CEOs to manage companies and global supply chains, trade larger sums, and access larger audiences more easily. Kaplan said he believes those elements, not poor governance, have bid up the pay of CEOs. He said that as firms become more valuable and technology has helped CEOs to affect that value, boards have responded by spending more to attract and motivate talent.

On whether CEOs are paid for performance, Kaplan presented data showing that realised pay is highly related to performance. He added that pay for performance is underscored by CEOs holding so much in restricted stock and options. In addition to financial incentives, CEOs also are held accountable by the risk of firing. Kaplan referred to a paper by Jenter and Lewellen looking at what happened to CEOs in the S&P based on their performance. The authors found that CEOs in the bottom quintile on performance were 60% more likely to lose their jobs, and the top quintile only 20%. This shows that boards aggressively fire CEOs for poor performance.

On company performance, Kaplan said that business has been doing very well. He said that corporate profits relative to GDP are near all time highs and the capital share of profits across the world are at an all time high. However, income inequality has gone up, particularly in the middle class where people have been hurt by technology and globalisation. Kaplan argued that income inequality has risen because companies are doing so well. He said that corporate profits have increased, potentially at the expense of those with middle incomes, but not due to poor governance.

To conclude, Kaplan said that the three most common perceptions of CEO pay are false: that CEOs are paid more and more, CEOs are not paid for performance, and that boards do not penalise CEOs for poor performance. He said the real challenge is that the market for talent naturally leads to high pay for people at the top. He said that a combination of visible high pay levels, examples of bad corporate behaviour and lacklustre gains for the middle class create outrage in society. This makes it difficult to pay enough to hire and retain talented executives, pay for performance, and at the same time not pay more than shareholders will approve and remain within political and public constraints. He said all these factors are very difficult to manage and he believes this is why private equity, which does not operate under all these constraints, has been hiring away talented managers.