Why has CEO Pay Exploded?

and What Can We Do About It?

(and What SHOULD We Do About It?)

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Why has CEO pay exploded?

CEO Total Pay (including grant-date option value)

CEO Cash Pay

Average Real CEO Pay (millions - 2005 dollars)
Why has CEO pay exploded?

- It’s the options!
- It’s the consultants!
- It’s the regulators!
- It’s the market!
- It’s the directors!
Why has CEO pay exploded?

Median CEO Pay ($0.5 mil)

- 1992: $2.4
- 1993: $2.5
- 1994: $2.9
- 1995: $3.1
- 1996: $3.6
- 1997: $4.5
- 1998: $5.0
- 1999: $6.2
- 2000: $6.7
- 2001: $6.9
- 2002: $7.0
- 2003: $7.4
- 2004: $7.5

Components:
- Salary
- Bonus
- Stock Options
- Other

Graph showing the increase in median CEO pay from 1992 to 2005.
US CEO Pay in 1992

- Options: 24%
- Bonus: 22%
- Salary: 38%
- Stock: 5%
- Other: 11%
US CEO Pay in 1993

- Salary: 37%
- Bonus: 24%
- Options: 23%
- Stock: 5%
- Other: 11%
US CEO Pay in 1994

- Other Stock: 10%
- Other: 5%
- Options: 28%
- Bonus: 23%
- Salary: 34%
US CEO Pay in 1995

- Salary: 31%
- Options: 28%
- Bonus: 24%
- Stock: 6%
- Other: 11%
US CEO Pay in 1996

- Options: 34%
- Stock: 6%
- Other: 11%
- Bonus: 22%
- Salary: 27%
US CEO Pay in 1997:
- Options: 38%
- Bonus: 21%
- Salary: 24%
- Stock: 6%
- Other: 11%
US CEO Pay in 1998

- Options: 41%
- Bonus: 20%
- Salary: 23%
- Stock: 6%
- Other: 11%
US CEO Pay in 1999

- Options: 47%
- Bonus: 18%
- Salary: 20%
- Other Stock: 10%
- Other: 5%
US CEO Pay in 2000

- Options: 49%
- Bonus: 17%
- Salary: 17%
- Stock: 7%
- Other: 10%
US CEO Pay in 2002

- Options: 47%
- Bonus: 17%
- Salary: 20%
- Stock: 8%
- Other: 9%
US CEO Pay in 2003

- Options: 38%
- Bonus: 21%
- Salary: 19%
- Stock: 12%
- Other: 11%
US CEO Pay in 2004

- Options: 36%
- Bonus: 22%
- Salary: 17%
- Stock: 15%
- Other: 11%
US CEO Pay in 2005

- Options: 32%
- Bonus: 22%
- Stock: 17%
- Salary: 16%
- Other: 12%
It’s the options!

- Granting too many options to too many people
  - The recent explosion in CEO Pay was largely driven by an explosion in grants of stock option
  - But, the option-grant explosion was felt throughout the corporate hierarchy: *it was not a CEO phenomenon*
It’s the options!

It’s not just the CEOs . . .

Average Option Grant

CEO
Top 5
Below
Top 5

1.5
1.7
1.9
2.0
2.6
2.4
2.5
2.6
2.1
1.9
1.7
1.3

0%
1%
2%
3%
It’s the options!

It’s not just the CEOs . . .
It’s the options!

- **Average Real CEO Pay** (millions - 2005 dollars)
- **Dow Jones Average**

- **CEO Total Pay** (including grant-date option value)
- **CEO Cash Pay**

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It’s the options!

- Why were so many options granted to so many people?
- Because boards and executives perceived that options were free (or at least cheap) to grant
- New accounting rules will help . . . but look what’s happened to restricted stock!
It’s the consultants!

- **Misusing outside pay consultants**
  - Inherent conflict of interest with integrated HR firms
  - Be wary of executive pay consultants who are used by the firm for actuarial or pay for lower-level employees
  - Analogy: auditing rules under SOX
  - Mis-use of surveys and the ratchet effect
It’s the regulators!

Average Real CEO Pay (millions - 2005 dollars)

CEO Total Pay (including grant-date option value)

CEO Cash Pay

It’s the regulators!

- Tax rules and disclosure backfired
  - Increased disclosure ==> increased pay
  - Cautionary tale for new SEC rules
  - $1 mil cap ==> increased pay
  - More options, higher bonuses, even higher salaries
Think about the “Bid-Ask” spread for CEOs

- The “Bid” is the lowest amount the CEOs would be willing to accept
- The “Ask” is the highest amount that firms would be willing to pay
- The spread is huge, and CEOs have been getting a bigger share

Why? And, how do we stop it?

It’s the market!
What’s going on?

Governance has gotten *better*, not worse

So, why has there been a shift in the bargaining power of CEOs?

Biggest pay raises go to outsiders

Irony: the market for CEOs is becoming more important!

**It’s the market!**

Outside Hires

- 15%
- 17%
- 26%
- 33%

70s 80s 90s 00s
It’s the market!

- Paying too much to new CEOs
  - Current process is a recipe for over-paying: “Joe Bachelder effect”
  - Broad parameters should be negotiated before the candidate is offered the job
  - Compensation committees should employ their own contracting agents, and should never pay for the candidate’s agent
It’s the directors!

- How directors have let pay get out of control
  - Judgment calls favor the CEO even in the most well-intentioned boardroom
  - Solving this problem involves more than changing the mix towards outside directors, but rather involves fundamentally changing the role of the board and how it relates to the CEO
It’s the directors!

- Directors must take control of the pay agenda
  - Plans and levels usually emanate from HR, and approved by top execs before going to the compensation committee to be blessed
  - Compensation committees must take full control of the compensation process, policies, and practices
It’s the directors!

- Directors must no longer see themselves as (effectively) the employees of the CEO
  - The board should be chaired by someone who is not the CEO, was not the CEO, and will not be the CEO
  - The CEO should be the only member of the management team on the board
  - Private equity (often) gets this right
Will this get pay under control?

- Let’s not kid ourselves . . . but it’s a start
  - Key source of the recent pay explosion was options, not bad boards
  - Increased disclosure is good, but will not curtail pay
  - Much of the problem with pay lies in the details of equity plans, bonus plans, and the way executives interact with capital markets
- So, there is still a lot of work to do . . .