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Executive Compensation and Public Outrage

What fueled public outrage wasn't how much execs got but how little the rest of us did, says Camelia Kuhnen of the Kellogg School of Management. The upside: increased shareholder activism

By Kellogg School of Management Faculty Members

Bonus season is well under way, and the public outrage that last year boiled over into protests at execs' homes, criticism from the President, and demand for reform from an angry public seems to be at a low simmer now. While there has been some criticism of the large bonuses taken home by top execs at companies that took TARP money, and many companies have changed their approach to compensation, there hasn't been the sweeping regulation and widespread reform that was demanded and promised, at least implicitly.

Professor Camelia Kuhnen of the Kellogg School of Management at Northwestern University, who has done extensive research on workplace incentives for CEOs, recently spoke with Bloomberg BusinessWeek.com's Patricia O'Connell about the relationship between public outrage and executive compensation, and why it's the responsibility of shareholders, not the government, to get involved. Edited excerpts of their conversation follow.

What do you think about the state of exec comp? It was a big issue a year ago, and people were expecting a lot of reform.
We've see the call for reform before. Back in the '90s, there was a similar sort of public outrage [and that led to] changes in the law. Cash pay had to be capped at $1 million [because] after that the tax implications for the company were more severe.

Companies invented other ways to pay CEOs that weren't subject to this cap. That's when you saw stock options take off as a form of CEO pay. …The public outrage recently has been about bonuses—the total value of pay that executives receive, especially these banking execs. So the issue is, if you regulate the way execs are paid, will they just come up with new ways to pay executives that aren't in violation of regulation?

Do you think exec compensation is out of line?
I don't think there is anybody who can say that they have the perfect model for what CEO pay should be. I can give you one [theory] that is very prevalent in the academic literature that gives a very rational reason why some CEOs are paid a whole lot.

The [theory] is…if you put together a very gifted CEO with a very large firm, wonderful things are going to happen. All of these large firms that we have seen show up in the economy would love to be matched with a very, very talented CEO. …This is all about supply and demand. There is nothing here [in this theory] about CEOs getting entrenched [with their boards so] they are able to extract large amounts of pay.

There is some truth to the [idea that it is about supply and demand] and there is some truth to the idea that some CEOs are too entrenched with the board.

Is the solution then to change the governance model?
If you have in place the right board of directors—people who do their fiduciary duty, who understand who the best CEO is, what is the right pay to attract and retain that person—if you have these people on your board, then you will have the right CEO and the right pay.

Were the bonuses we saw for 2009 that just got handed out appropriate or not?
It is hard to justify why CEOs of firms that got bailed out got bonuses.

What about the companies that have paid back the TARP money?
As long as the government is no longer involved in the firm, it is up to the shareholders and to the directors to decide what is appropriate pay.

I don't know who said this: "People get the leaders they deserve." I think shareholders get the CEOs they deserve. If shareholders don't pay attention, if they don't elect good directors and they don't monitor management and go to meetings, they might get stuck with the CEOs they deserve.

Is it really about individual shareholders? And last year we saw a lot of outrage that wasn't even coming from shareholders.
Shareholders can vote with their feet. Institutional investors can put forth proposals about pay and management. I see no reason why if they care about their money they wouldn't pay very good attention to what the board and the management are doing.

The public outrage about pay is a wake-up call for shareholders themselves to pay attention [and make sure] that they have the right people sitting on the board, that the CEO is being monitored very well.

It's good to have the public outrage. It makes shareholders ask, "Do we have the right strategy?" "Do we have the right leader and is he or she being paid the right amount?"

Should the government be involved in regulating pay?
You want to have public outrage because this makes shareholders pay more attention, but you don't want outrage to lead to government intervention just to please the public. I don't think regulation is the answer.

Shareholders can get more involved and they can keep a better eye on management. But they really need to understand who is on the board of directors and the relationships between the board and the management of the firm. Research has shown that these relationships are quite important. You want to have independent watchdogs on the board.

So the solution is better governance, not government?
We don't want government intervention. We like shareholders to be given the opportunity to monitor management.

What do you think we will see from now on?
I think salary and restricted stock will be the preferred way to incentivize executives.

Do you think when the economy hopefully rights itself and we're clearly in recovery and everyone is feeling good again that this issue will die down?
I think so, because this public outrage is fueled not by the fact that the CEOs got so much money but that the rest of us got so little. When the economy is doing well and everybody is making money, Americans are very

comfortable with having their CEOs paid a lot.

But when we hit a rough patch and the economy tanks and people start losing their jobs and they start having their salaries cut, but they see that their CEOs are still making millions of dollars, you are going to get outrage. And that outrage leads to these shifts in CEO pay.

Camelia Kuhnen is an assistant professor of finance at the Kellogg School of Management at Northwestern University. Professor Kuhnen studies incentives in the workplace and she also studies the micro-foundations of financial decision-making by investigating the brain mechanisms responsible for learning and risk-taking in financial markets. For more information about the Kellogg School of Management, including its MBA and its executive education programs, visit www.kellogg.northwestern.edu.

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