Punting Peer Groups: Resolving the Compensation Conundrum

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"Say-on-Pay" and, more fundamentally, long-sought board compositional reform will not solve the ongoing controversy over executive pay in this country. Overreaching executives, coupled with indulgent corporate boards, certainly played a major role in escalating pay to the levels that resulted in popular and shareholder outrage. However, we may never end this debate unless we address critical flaws in the mechanics of the process by which boards set pay.

We have long struggled to assign an appropriate value to the application of an executive’s talents and leadership. The level of compensation is rarely, if ever, targeted below the 50th percentile. To do so would place the board in an uncomfortable and disadvantageous position. Pay below the median does not simply send a message of the relative performance and merit of an executive, as embodied in one’s compensation relative to one’s peers. Instead, such action may raise concerns over the executive’s position within the company, possibly undermining that individual’s ability to lead effectively.

Additionally, boards seemingly use the 75th and 90th percentiles as a common method to signal institutional aspiration and standards, in the same way that the terms “better” and “best” are designed to enhance product differentiation. In a similar sense, pay below the median would consequently signal “worse.”

Selecting a Peer Group

There are problems with the use of peer groups that have led to the ratcheting up of executive pay. Traditionally, critics have argued that the manipulation of the selected peer comparison companies distorts the pay process. Where boards are dominated by management, there is a natural incentive to pick as peers companies with significant compensation, despite differences in size, scope, and performance from the company in question. The higher the compensation of one’s peers, the higher the consequent compensation of the target company executives.

This manipulation of the peer group sampling is a real problem. But simply eliminating such machinations will not ultimately solve the pay issue. As discussed, boards typically gravitate in setting compensation to a set of arbitrary targets—

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i.e., the 50th, 75th, and 90th percentiles of peer group pay. A blind reliance on these pay targets has resulted in a mathematically-based upward pay spiral. If all aspire to be above median, it is clear that pay has and will continue to rise significantly and indefinitely.

This process of company-to-company comparisons and percentile targeting has distorted the pay decisions of even the most shareholder-conscious boards.

These criticisms aside, this construct creates a perverse reward structure. The peer grouping process fails to consider the actual talents and abilities of the executives themselves. Individual merit becomes almost irrelevant when making the company-to-company peer comparisons.

An individual executive may deliver phenomenal performance and be likewise compensated, but why should that individual’s contribution to their company be relevant to another individual’s actions at another company on an absolute basis? Comparisons to that individual must not be so unconditionally based.

Executives are not freely interchangeable; their performance will be different than another’s at every company they head. A talented individual who is paid on a scale deserving of his or her abilities should not through the peer group mechanism be allowed to bolster the pay of less able executives; particularly when those executives would be paid less if serving in a similar fashion, due to a performance-based decline in pay.

Blind matching of pay through peer groups and percentile targeting fails to identify for boards the most crucial component to the negotiation. Peer grouping, by focusing simply on absolute pay levels in making an elementary company-to-company analysis, fails to determine the intrinsic worth of the executive in question and does nothing to identify the outside opportunities available to an executive that are necessary in determining a retention wage. For this, pay structures must be tempered by a specific consideration of an individual’s talent and that person’s actual external opportunities.

A Different Approach

So what is the solution? An efficient negotiation process determines the level of pay necessary for a CEO’s retention—no more or less should be paid. Once an appropriate amount is determined, boards can devise an appropriate mix of cash, stock, and/or options which will create the required incentive.

For the purposes of determining this amount, a realistic appraisal of the executive’s outside opportunities as measured by that individual’s historic performance record and experience needs to be made. An executive’s past actions are a useful indicator of future performance.

By inquiring into the intrinsic worth of an individual’s contributions, rather than blindly referencing the pay of others, we can arrive at more equitable and less controversial compensation.

A universally applicable, consistent, and objective metric to evaluate a CEO’s performance, regardless of industry or company size, can be formulated as a gauge for relative effectiveness. Such a uniform metric, developed by using a blend of measures such as return on assets or revenue growth, can be applied by boards in creating an appropriate level of compensation for the executive concerned. Rather than using peer group analysis based on firm attributes, boards should use this individual-centric process in determining the appropriate level of pay.

By inquiring into the intrinsic worth of an individual’s contributions, rather than blindly referencing the pay of others, we can arrive at more equitable and less controversial compensation. This will bode well for the health of the corporation and, more importantly, its shareholders.