Peer Pressure: Is Benchmarking to Blame for Runaway CEO Pay?

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October 02 2012

As scrutiny of soaring executive pay continues, the latest source of hand-wringing is how companies benchmark against peer groups—the group of CEOs at similar companies that compensation consultants use to help set CEO salaries and benefits packages.

Ideally, evaluating executive pay in light of what others get at companies in the same industry and of roughly the same size is a good way to gauge the market price for top executive talent. However, critics, such as proxy advisory firm ISS, say that boards are too-willing to game the process by including companies with large pay packages and then giving out the highest percentile of pay they can as an act of either industry one-upmanship or a symptom of an all-too-cozy relationship with the C-suite.

A new study by researchers at the John L. Weinberg Center for Corporate Governance at the University of Delaware faults the use of compensation peer groups as flawed and easily manipulated. The authors, Charles Elson and Craig Ferrere, blame an over-reliance on peer group benchmarking as the central cause of skyrocketing executive pay in the United States.

While the top complaint of executive compensation critics is that compensation consultants and compensation committees lump dissimilar entities into the peer groups they use, the study finds that this is only part of the problem. Even when the peer groups are fairly constructed, they are not necessarily used in the proper context, the study's authors say. “Peer group comparisons are central to the CEO ‘mega pay machine' problem,” says Elson. “Even the best corporate boards will fail to address executive compensation concerns unless they tackle the structural bias created by external peer group benchmarking metrics.”

Instead, Elson says boards should curtail the influence of the peer group analysis and rely more on performance measures and internal metrics. “If customer satisfaction is important to the company, then results of customer surveys should play into the compensation equation,” Elson says. “Other internal performance metrics can include revenue growth, cash flow, and other measures of return.” Another consideration, he says, should also be internal pay equity.

The report is sparking water cooler chatter among compensation consultants. While little of what the Center for Corporate Governance paper recommends as good business practices finds much disagreement, some are taking issue with how peer grouping has been tied to the whipping post.

Still, compensation consultants admit that the peer-group benchmarking process is an inexact science. “I'm an accountant by training and always chasing every single penny that didn't count out right. But,
if you have to search for exact numbers, market pricing will make you crazy,” says Steven Hall, founding partner and managing director of the compensation consulting firm Steven Hall & Partners. “There is no perfect group in any case. We are just trying to get close. I'd be happy to consider other ways of looking at these things, but you've got to have some starting point.”

Hall says compiling peer groups is seldom as easy as it seems. Working with a regulated utility, for example, he initially thought a comparison of similar companies would be straightforward. His client's demands quickly proved otherwise. Finding truly comparable executives wasn't just a matter of grouping companies by revenue. Also in the equation was the cost of providing that power and how much was generated to reach those revenue targets. The specific expertise needed to oversee nuclear power or the ancillary services some utility companies offer, such as phone service and cable television, also made useful executive-to-executive comparisons difficult. “We kept yelling, ‘uncle, uncle,’” as the client's list of necessary comparison criteria grew and grew, says Hall.

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—Charles Elson,
Director, Weinberg Center for Corp. Governance,
University of Delaware

Selling the Compensation Story

Part of the difficulty, according to some compensation experts, is that some shareholders look past the complexity of executive compensation and over-simplify the issues. The process of devising a pay structure takes considerable time, care, and expertise, says Todd Sirras, managing principal for the executive compensation consulting firm Semler Brossy. But trying to sell it to a broad marketplace (shareholders) often reveals that they don't fully appreciate all the nuances.

How you tell your story is crucial, especially as the corporate world faces the “say-on-pay” requirements of the Dodd-Frank Act, he says. Public companies must provide shareholders with a non-binding vote on how executive officers are paid at least once every three years. Peer group data is among the metrics used by proxy advisers in guiding those votes.

Executive pay plans must now be constructed to pass muster on say-on-pay votes, adding another layer of complexity. “We are consultants but we are also in this position now of doing investor relations, because we need to tell a story that is digestible to folks,” Sirras says.

The Center for Corporate Governance study is highly critical of “a formulaic reliance on peer grouping.” Sirras agrees with that warning, but he takes issue with claims that peer groups are formulated with the goal of increasing executive pay.

Semler Brossy's research does show that companies include competitors that are slightly larger in the peer group, however, Sirras doesn't think it is done to create an “upward bias” for pay decisions. “It's the aspirational element of it,” Sirras says. “An asset manager that puts BlackRock in their peer group doesn't necessarily do it because they want to pay like they do, but because that's the 800-pound gorilla in the industry.”

The following is an excerpt from the research paper, “Executive Superstars, Peer Groups and Over-Compensation – Cause, Effect and Solution.”

The boards of most U.S. public companies set executive compensation through the use of a mechanistic process
referred to as “peer grouping.” Typically, boards engage compensation consultants who aid in the structuring of the pay package to be negotiated with the executive concerned. These consultants, advising the board's compensation committee, are asked to put the proposed pay package into some perspective vis-a-vis the overall competitive job market. To do so, they construct a framework of comparative metrics based on the level and structure of pay at companies deemed similar — as selected by the compensation committee and consultants, often with varying degrees of input by management. The executive's proposed compensation is based on this comparison. Generally, after the peer group market analysis is completed, the board will choose to create a package that is usually targeted at the 50th, 75th, or 90th percentile of their target peer comparison group. Targeting levels below the 50th percentile is rarely, if ever, done.

But, why these levels? It is because any other action would seemingly place the board in an uncomfortable and disadvantageous position. In the current construct, pay below the 50th percentile 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 board 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.”

After the compensation committee selects the appropriate percentile level, a package is then designed by the consultant to meet the specified numerical goal. This is typically accomplished by using a mix of salary, bonus and long-term incentives— usually restricted stock or stock options. The package so created and recommended by the compensation committee is then approved or ratified by the full board.

CONCLUSION

The external benchmarking of executive compensation has contributed significantly to the problem of high and rising pay in the United States.

It is increasingly apparent that the pay awarded to chief executives is becoming profoundly detached from not just the pay of the average worker, but also from the companies they run. Offsetting the external focus, which is so heavily relied upon today, with internal metrics and internal benchmarking may help to curb the persistent escalation.

We hope that if directors are no longer constrained by notions of “competitive” pay, which are driven by the false belief that CEOs are interchangeable, they may have the space to rationalize the upward spiraling pay ratchet and deliver what is more shareholder acceptable compensation. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most importantly, a healthier, more competitive corporation.

A hard and honest focus on the company itself and the accomplishments of the executive in question by the board, rather than blithely looking externally to other organizations, will best serve the company's and the shareholder's interests. Through this careful focus, any potential difficulties and costs can be mitigated. Likewise, regulators and the courts must recognize the dangers inherent in over-reliance on the flawed peer process by boards and adjust their approaches to the pay issue accordingly.

Deemphasizing the peer group process in setting pay may not prove the comprehensive cure to the overcompensation problem, but the costs of pursuing this approach are minimal and it is a good beginning.

Source: Superstars, Peer Groups and Over-Compensation – Cause, Effect and Solution.

Proxy Advisory Peer Groups

Compensation consultants aren't the only ones building peer groups. Proxy advisers, chief among them
Institutional Shareholder Services (ISS) and Glass Lewis, also create their own for formulating decisions on whether to recommend positive say-on-pay votes. Frequently, these peer groups are much different than the ones compensation committees use to set pay and that has led to more debate on pay benchmarking. Critics have derided the peer group constructions of proxy advisers as both “one size fits all” and including companies with very little real world connection to what they do.

ISS’ methodology for peer groups uses Global Industry Classification Standard codes (a multi-tiered breakdown of companies by sector and industry that was developed by Standard & Poor's and MSCI), as well market capitalization, and other comparisons. It attempts to select peer companies that are both larger and smaller in order to position the subject company at or near the median of them.

Glass Lewis recently announced a new methodology that uses an algorithm developed by executive compensation data provider Equilar that guides peer group selection by looking at those used by the subject company, as well as their reported peers. It also selects from companies that chose the subject company for its peer group.

This year, in offering a negative say-on-pay recommendation, ISS took issue with JCPenny picking companies with much higher revenues (among them Disney, Target, and Pepsi) for compensation analysis. In turn, JCPenny, like the Marriot Hotel Chain, protested ISS peer groups that included auto part chains.

The proxy adviser, however, has both defended its methodology and offered to work with companies to improve it. The disconnect can partly be blamed on having different objectives. “Our purpose is very different than a company's purpose in benchmarking,” Carol Bowie, ISS' head of compensation research told Compliance Week in March. “They are looking at companies they believe they compete with for talent; we are looking at it from the shareholders' perspective.”

A survey released in September by the accounting and consulting firm BDO USA, found that a majority (59 percent) of corporate directors of public company boards believe that the peer groups used by proxy advisory firms for executive compensation comparison purposes are not an accurate reflection of their company's peers. When asked for the most important criteria, “industry” was cited most often (61 percent). Revenues (15 percent), human capital competition (13 percent), and market cap (11%) all ranked lower.

**Getting It Right**

What goes into a proper peer group selection? Sirras says there are two key elements. The first is ensuring that the closest business competitors are the most prominent. The second is “being very explicit” about how that data should be used.

One of the problems is that boards often decide to pay toward the high end of the scale, rather than the middle, a practice, says Sirras that is starting to subside. “Over the past two years, I've see a real shift towards median pay positioning against the peer group, with the opportunity to earn above that level with good performance,” he says.

“When companies do benchmarking, it is exactly what it means. They want to see where they are in relation to their peers,” says Randy Ramirez, senior director of compensation in the Corporate Governance Practice of BDO USA. “It is not a hard-and-fast guideline or something that is followed. They want to see where current practices are and keep a close eye on their competitors.”

There are challenges for public companies that try to link executive compensation with performance. One of them is that they may need to guard the details of internal plans from competitors and, hence, the public. That means executives could be meeting internal goals for which they earn higher pay, but the company could have difficulties providing transparency on it for competitive reasons.

For example, a company hit hard by the economy may craft a plan that involves a retooling of its operations and
significant infrastructure investment. That outlay however may not be evident to shareholders for three years as the stock price remains stagnant. An executive may therefore deserve greater pay than the public might be willing to support, if he or she is meeting the internal goals established in the compensation plan, especially if the strategy is shielded from competitors and, in turn, the marketplace.

“Stakeholders do not have access to all of the proprietary information that goes into compensation decision making, and if they did that would really leave a lot open to competitors,” Ramirez says. “It is two-pronged. You have to have this strategy for the public, and then you have the double secret strategy of what you are working on so that when finally you can make that public it makes sense.”

In creating a quality list of peer groups, Ramirez suggests including those who are true competitors—“the people you run into when you are sitting with a client and bidding on a project.”

“It is not just by Standard Industrial Classification (SIC) code,” he says. “You could be in the same industry and not be a competitor.”