

WORKING PAPERS

WHY IMPOSING LIMITS ON EXECUTIVE COMPENSATIONS? RECOMMENDATIONS FOR SPAIN

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WP
2/2009

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This paper has been prepared in the context of the conference “Global Progress – Towards a Global New Deal” organized by the Ideas Foundation and the Center for American Progress in October 2009 in Madrid.

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Published by IDEAS Foundation
Gobelas 31, 28023 Madrid
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Fax. +34 915 820 090
www.fundacionideas.es

ISBN: 978-84-937884-8-3
Depósito legal: M-23520-2010

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Introduction

International debate on the role of compensation systems for the executives of large corporations is currently at its peak, focusing in particular on the compensation formulae for executives in the financial sector, which it is considered one of the causes originating the current economic crisis. The debate has been heated by a public perception that it is incompatible for governments to be spending huge amounts of resources to support the ailing financial sector, while at the same time some executives in that same sector continue to earn outrageously high compensations. Many voices are claiming in favor of introducing some kind of regulation.

Executive compensation was one of the issues discussed at the G-20 Pittsburgh Summit on 24-25 September 2009. The G-20 world leaders stated that “excessive compensation in the financial sector has both reflected and encouraged excessive risk taking”, and agreed upon several recommendations to reform compensation practices in order to support financial stability. However, for these recommendations to be effective, they have to be satisfactorily implemented by firms, and we may expect a strong opposition from financial institutions and those executives affected.

Positions in the debate are far from getting any nearer: some openly question the need for the public sector to play any role whatsoever in the remuneration of private companies’ executives, whereas at the other end, opinions can be found in favor of a strict regulation of executives’ pay in those businesses receiving public money.

In December 2008, the Ideas Foundation presented a report including proposals to improve the functioning of financial markets, which identified the origins of the current financial crisis and proposed solutions for the future¹ In that document a

1 *New Ideas to Improve the Functioning of Financial Markets and the World Economy: Ten Major Reforms to Respond to a Systemic Crisis*, available at www.fundacionideas.es.

first discussion was already hinted on the role that current executive compensation systems may have played in the current global economic crisis we are undergoing.

The purpose of this article is to delve deeper into this issue, analyzing what the impact may have been in the crisis and whether the public sector should play any role as regards executive compensation at large companies operating in several key sectors for an economy (such as the financial sector or some other sector liable to introduce a systemic risk) to help improve risk allocation.

After describing the measures that some countries have already implemented or are considering on the issue of executive compensation, and briefly presenting some empirical evidence on the evolution of executive pay during the last decades, we carry out an analysis of executive compensation systems based on incentive mechanisms. In particular, we want to assess the role that such mechanisms may have played in the generation of the current global economic crisis, and what solutions may be proposed from a theoretical standpoint.

On the basis of our analysis, in the last section of this document we propose a number of measures applicable to the Spanish case, which may help to re-define executive compensation systems, in particular in the financial sector, in order to contribute to financial stability and to achieve more effective results from a social point of view.

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International Debate on Executives' Compensations

The two main laws enacted in the United States (US) by way of emergency to bailout the financial sector with public money, and to avoid the global collapse of the system, have started to address for the first time the taboo of eventual limits on compensations of banking executives, on the basis of their responsibility in the financial collapse.

In April 2009, the US Treasury Department issued guidelines in which it considered imposing a 500,000 USD cap on the annual compensation of senior executives at companies receiving federal bailout funds. Subsequently however, the White House was reluctant to establish any specific caps on compensations, on grounds that competition between companies bailed out or not, in the hiring of senior executives, may result in a shift towards those institutions offering higher salaries.

Consequently, in August 2009, the US Congress granted powers to the Government to prohibit salaries and bonuses that it considered could incentivize “an inappropriate risk”. Furthermore, it was also agreed to modify the legislation so that the shareholders will be given more say about how to reward executives on the basis of results. Since then, Kenneth Feinberg is the man in charge of examining compensation practices in companies receiving public subsidies and of ensuring that these companies “achieve an adequate balance between the need to retain staff, reward performance and protect the tax payer’s investment”.

Following the US initiative, the United Kingdom, France and Germany started to consider similar measures. So far, in France and Germany (especially in the former), the political rhetoric against excessive compensations has been far stronger than

the legislative actions actually implemented. However, in the United Kingdom, the debate has maintained a much lower profile, while actions are more specific. For example, the Financial Services Authority (FSA) shall require, starting January 2010, that companies distribute bonus along a period of three years, instead of their being paid up front, in order to link compensations to the results of senior executives' management.

Anyway, the reason why this issue was linked, from the very beginning, to the G-20 discussions agenda was the need for all countries to coordinate measures. Otherwise, senior executives could easily concentrate only in those countries/institutions with more flexibility to establish compensations, thus unbalancing the competition between the financial sectors in the different agents in the system. As anecdotal evidence of the above, the British newspaper *The Times* recently reported that 45 Barclays executives and 20 Société Générale executives have opted to change company to avoid monitoring of their remunerations. The group of 45 executives will work for a new company called Protium, associated with Barclays and with registered offices in the Cayman Islands. From this tax haven, it will manage troubled assets of the bank for an amount of USD 12.3 billion, and will pay its executives a minimum of USD 400 million in the next ten years. The other 20 senior executives of Société Générale have left their positions to disembark in the hedge fund Nexar Capital.

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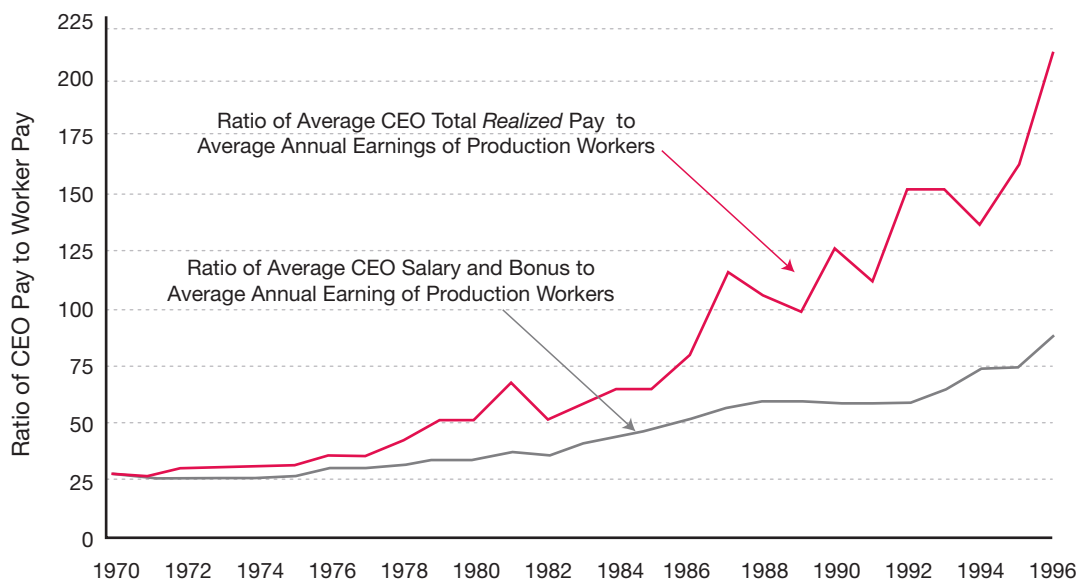
Empirical Evidence Regarding Executives' Compensation

Beyond journalistic anecdotes and high-flown statements by some politicians, it is important to justify, with data, where the root of the problem to be addressed lies. Empirical evidence shows that executive compensation in large companies has been increasing exponentially from the 80's to this date, so that growth rates for the compensation of executives have been much higher than growth rates of workers' salaries.

In the United States, for example, Murphy (1999) presents a comparison between compensations of the CEOs of the 500 largest companies with the salary of the average worker. Chart 1 shows how in 1970 the difference between them was already large; executive compensation was already 25 times higher than that of the average salary. Likewise, it is worth noting that in the 70's the executive compensation system was only based on a fixed salary plus a variable bonus; there was however no significant remuneration linked to the results of the company, measured on stock value or any other market reference.

On the contrary, towards the end of the 80's we see that the latter type of compensation has increasingly gained relative substantial weight in the total remuneration packages of company executives, and this trend skyrocketed since the end of the 90's. In 1996, the aggregate salary (including both fixed and variable tranches) of the main executive in a company was already 90 times the average worker's salary. If, however, we include in the package the revenues obtained by the executive through stock-linked remuneration formulae, this difference increases significantly, to a point where the aggregate remuneration multiplies by over 200 the average worker's salary.

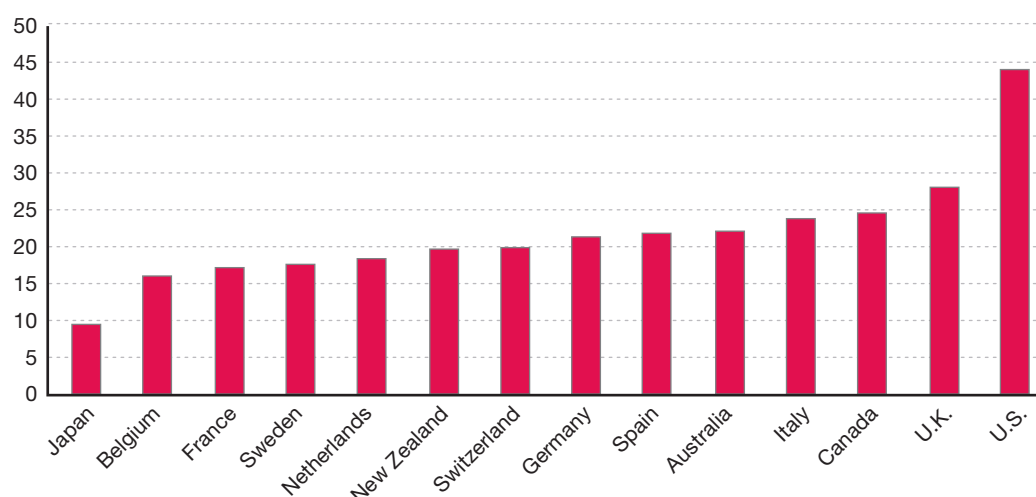
Chart 1. Difference between the remuneration of executives and workers. United States (1970-1996)



Source: Murphy (1999)

When doing this kind of comparisons between the salaries of executives and average workers, it is difficult to systematize studies in order to have homogeneous data available, since the items included or excluded in the compensation package of executives generate significant differences in results. In any event, it appears evident that the trend observed in the decades since the 70's has continued increasing in the last decade. Burton & Weller (2005) point out that in 2004, the average pay of CEOs in the major American companies was around 9.2 million USD, which multiplied by 240 the average wage.

Likewise, it is not easy to carry out reliable international comparisons on executive compensations, because this would require knowing what kind of items are included in the remuneration in each country. Several studies coincide in pointing out that executive remunerations in the United States are well above those in other countries, as shown in Chart 2, which shows the ratio between total pay of executives/average pay for several countries.

Chart 2. International comparison of the ratio executive pay/average pay (2004)

Source: Economic Policy Institute (2005)

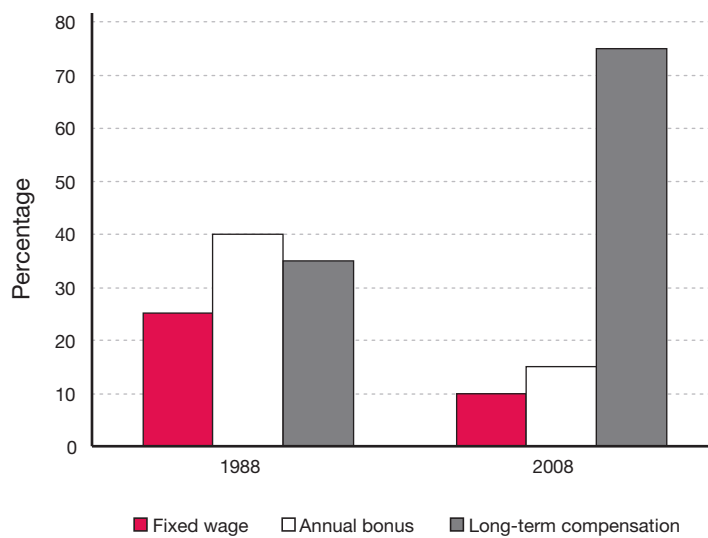
Empirical evidence available on executive pay shows that remuneration systems consist of three components: a fixed base salary, a variable annual remuneration depending on accounting results (known as “*bonus*”) and an incentive-linked remuneration that we can call “*long term*”, generally associated with stock options or some other type of earnings linked to the value that the company achieves in the market. The objective of this latter type of remuneration is to attempt for the incentives of executives in the decision-making process to be aligned as much as possible with the interests of the companies’ owners.

The respective weight of each of the three components in the aggregate remuneration varies from one country to another, and also from one sector to another of the economy, but it can be generally said that long term remuneration has been expanding in recent decades, to a point where it accounts for the largest percentage in the pay of high executives.

A recent study by Boston Consulting Group² indicates that, in the case of executives of the leading companies in the United States, the last 20 years have witnessed an enormous leap in the long-term remuneration, this component having surpassed even the variable bonus. In 2008, long-term compensation was already at around 75% of the total remuneration collected by executives (see Chart 3).

2 Hansell, Luther, Plaschke and Schatt (2009). The data used correspond to executives’ compensation in the leading companies in the United States, including all sectors.

Chart 3. Relative weights of executives'



Source: Boston Consulting Group

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Why Do Incentive-Based Schemes Prevail in Executives' Compensation?

Economic theory provides the basic arguments explaining the reasons why we see this global trend prevailing worldwide, perhaps more noticeably in the United States, probably due to the larger average size of US companies, of using variable compensation systems to pay executives at large companies.

The “principal-agent” theory explains why the separation between ownership and management in a company entails that the interests of executives do not necessarily align with the interests of owners, and the latter have much less information available than managers to assess whether the decisions taken in the company are the most appropriate to maximize their objectives.

Therefore, instead of remunerating executives with a fixed salary, it is preferable to link their compensation to the results obtained by the company. Generally, shareholders pursue a maximum return on their investment, by way of dividends and revaluation of the stock, so that linking executive salaries with objective measures, allowing an assessment of results obtained through their management, makes perfect economic sense³.

During the 80's and in parallel to the rapid growth of executive pay, the issue has spawned an enormous economic literature, intending on the one hand to analyze from a theoretical standpoint which would be the best incentive-based mechanisms, and on the other hand to empirically verify which are the systems used in practice.

3 For an excellent review of problems arising with agency in companies and of the mechanisms available to solve them through remuneration systems, see Bebchuk and Fried (2003).

The main arguments stemming from this literature regarding the use of long-term remuneration systems based on paying executives by means of options on the company's stock are the following:

- The wealth of executives, and not only their annual remuneration, should be aligned as much as possible with the wealth of shareholders, so as to cause the executive to pursue the same goals in which shareholders are interested (Jensen and Meckling, 1976). The above would lead to the company fostering and incentivizing the purchase of its own shares by the executives, but in turn would reduce the incentive effect of paying through stock options. Those executives holding a large portfolio of shares already experience strong variations in their wealth through changes in the value of the company, and are therefore less motivated to obtain options.
- More veteran executives nearing the end of their career may have less incentive to take appropriate medium term decisions if their salary is linked to short-term accounting results. This result has been examined, for example, by Smith and Watts (1982), Dechow and Sloan (1991), or Murphy and Zimmerman (1993). For this kind of executives, the fact that they obtain a part of their remuneration by way of options to purchase shares guarantees that decisions on research, development and innovation programs yielding medium term results will be correct, since the executive can benefit from the company's growth beyond the horizon of his/her own employment with the company (either because the market reaps more rapidly the expectations on the company's value or because results improve in the future).
- In sectors with strong growth perspectives, companies should use incentive-based mechanisms. Many studies analyzing investment decisions, such as for example Holmström and Ricart-Costa (1986), Smith and Watts (1982) or Bizjak et al. (1993), point out how executives normally have privileged information available on the value of growth opportunities for the company. Therefore, remuneration systems based on stock options incentivize executives in these sectors to take appropriate decisions.
- In highly leveraged companies, compensation systems based on stock options should be less used. John and John (1993) analyze in a theoretical model the relationship between executive compensation systems and the capital structure of the company, and come to an interesting result. If an executive is paid through a system that strongly incentivizes him to aim for a high return on

capital, then agents acquiring the company's debt will claim high premiums to hedge against the possibility of the executive taking risky investment decisions, which would entail a transfer of revenues from bondholders to shareholders. Therefore, in order to reduce the costs of debt, incentive-based remuneration systems should be limited in highly leveraged sectors. As we will see below, this recommendation has not been followed in the financial sector which, by the very nature of its business, is a highly leveraged sector.

- Companies working in sectors with a high level of variability in their annual results should use compensation systems linked to the market value of the company. If the executive remuneration system relies on bonuses linked to the company's annual results (such as turnover or profits) and these results are subject to high variability due to exogenous reasons outside the control of executives, it is preferable to link the compensation to the value of the company measured according to the market perception of the decisions taken by executives. As an example, in the airlines sector, market fluctuations are usually abrupt, and they are generated by exogenous events, which do not depend on the management of the business or on the investment decisions of executives (rises in oil prices, air accidents, or the 11-S terrorist attacks, for example). Therefore, in this kind of sectors it is preferable to use payment systems based on stock options, rather than bonuses linked to accounting variables. As Lambert and Larcker (1987) point out, the compensation of executives must be linked to signals that shareholders can monitor and which show lower levels of noise (accounting variables or value of the share in the market).

In short, we see that economic literature provides a wide range of arguments justifying large companies, in particular in certain sectors, to widely develop incentive-based remuneration systems, and in particular stock options and other mechanisms linked to the value of the company.

In general terms, the recommendations that may be derived from this literature are the following:

- Remuneration mechanisms based on incentives should align the goals of executives with those of the shareholders, especially regarding those strategic decisions affecting the value of the company and the level of risk it assumes.
- Remuneration systems should be based on measurable variables, monitorable by all agents involved in the company (shareholders, lenders, regulators), and should keep a relation as close as possible between the variable chosen as a

reference and the pay received by the executives. Thus, for example, there is little sense in mid-range executives in a company being significantly rewarded through stock options, reflecting changes in the value of the company arising from strategic decisions that they cannot make.

- Incentive-linked compensation should reward a good management practice, increasing the actual value of the company, and not merely increase value in a fictitious manner, for example through speculative bubbles that only apparently raise the market value of a company. In this respect, making variable remuneration systems depend on how well the company is doing with respect to a benchmark group made up of competing companies operating in the same sector is a way of avoiding excessive executive salary increases, which would not be rewarding proper management.

5

Remunerations in the Financial Sector and the Global Economic Crisis

Over the last years, the financial sector has widely been using the remuneration systems based on long-term incentives analyzed above, with a frequency even above the average of other sectors. What role may these variable compensations have played in the generation of the global economic crisis we are currently undergoing?

The existing evidence suggests that the compensation system for the financial sector executives is the root of the crisis that started in 2007-08. It would seem that the abuse of this kind of compensation systems, which favor taking excessive risks, largely explains the high leverage level in this sector that gave rise to the financial collapse.

Remuneration formulae based on stock options, widely used in the banking sector, cause executives to have interest in taking very high-risk decisions, with which a financial institution may earn a lot of money, but it may also lose it. Despite the fact that these type of transactions that have a negative expected value (i.e.: where it is more likely to lose than to win), should not be accepted, a financial executive rewarded by way of stock options would have an interest in the company engaging in it, since he or she will reap the benefits if the result were favorable, but will not assume the losses if the opposite would proves true.

An example taken from the work of Bebchuck and Spamann (2009) clearly illustrates this unintended adverse effect:

- a) Banking is a business that, by definition, entails a problem of moral hazard in all management decisions. Let us consider a bank holding assets for EUR

100 M, of which EUR 10 M are equity and EUR 90 M are deposits. For the shareholders of the bank, a transaction in which the bank may lose EUR 20 M with a 50% probability or win X with a 50% probability is interesting, even if X is lower than EUR 20 M (a situation in which the expected value is negative). Why are the shareholders interested in a transaction with a negative value? Should the result be adverse, they would only lose their EUR 10 M of equity, whereas the rest of losses would be borne by the savers having made deposits in the bank, or by the government if a guarantee exists on deposits. Since savers cannot supervise the bank's decisions, this is the main reason why a regulation exists on this sector, reducing, albeit not eliminating, the level of risk taken by financial institutions.

- b) The leverage level of the bank increases high-risk decisions. According to the Basel rules, up to one third of the required equity may consist of long-term debt. Let us assume that the bank mentioned above has EUR 8 M in stockholders' equity and EUR 2 M in the form of debt. While the bank in the above example could be interested in transactions in which it may lose EUR 10 M or more (since beyond such figure, the shareholders do not care), it will now accept transactions with a negative value in which EUR 8 M or more can be lost, which increases the range of high-risk decisions that may cause the institution to go bankrupt.
- c) The existence of financial holdings grouping banks with other type of businesses further increases the incentives to assume risks. Let us imagine now that this bank belongs to a holding company that owns the 8 M equity of the bank and another business with assets valued 100 M. Total assets of the holding company are therefore 108 M, and they are financed with a 16 M equity and 92 M debt. Let us consider that the other business of the holding company is a low-risk investment fund: with a 50% probability it may earn EUR 10 M and with a 50% probability it may lose EUR 10 M.
- If the fund loses EUR 10 M: the capital of the holding company is reduced to 98 M, so that, after paying the debt of 92 M, the shareholders only receive EUR 6 M.
 - If the fund earns 10 M: the capital rises to 118 M, so that after having paid the debt, the shareholders obtain 26 M.
- d) Banking executives are usually rewarded through shares of the holding company, not with shares of the banks they are managing, which incentivizes

them all the more to take risks, as we can see if we take the above example a little further: Let us consider that the bank can engage in a transaction in which it may lose 8 wM with a 50% probability, and with the other 50% it earns 8 M, and that this transaction is irrespective of the results of the investment fund. In this case, we need to combine the results of the performance of the banking business with those of the investment fund (See Table 1).

The following conclusions can be drawn from Table 1: since each box would have a 25% probability of occurring, the expected value for the shareholders is of EUR 16.5 M. Consequently, it is attractive for the bank executive to engage in high-risk transactions of the type we have analyzed, in which the losses are as high as the whole capital of the bank, but the potential earnings are also high, because if he or she holds shares of the holding company in his wealth (or is rewarded through options on such stock), he is well-off.

Table 1. Diagram of earnings and losses for the holding company

| | Fund loses 10M | Fund earns 10M |
|----------------------------|--|--|
| Banking business loses 8M | <p>Assets of Holding = 90</p> <p>The debt of the holding cannot be repaid in full (losses = 2 M)</p> <p>The shareholders of the holding company lose their 16M of capital.</p> | <p>Assets of Holding = 110</p> <p>92 M of the holding's debt are repaid</p> <p>The shareholders of the holding company obtain 18 M (earnings = 2 M).</p> |
| Banking business earns 8 M | <p>Assets of Holding = 106</p> <p>92 M of the holding's debt are repaid</p> <p>Shareholders receive 14 M (losses = 2M)</p> | <p>Assets of Holding = 126</p> <p>92 M of the holding's debt are repaid</p> <p>Shareholders receive 34 M (earnings = 18M)</p> |

Source: Bebchuck and Spamann (2009) and produced by the authors

- e) Lastly, and even more worrying, is the fact that, with these compensation schemes, the bank executive will also be attracted by banking transactions with a negative expected value, that is transactions in which on average more is lost than earned, but individually considered, the executive will still make money. In the above example, the executive managing the bank would be attracted to engage even in a transaction in which, with a 50% probability, 8M will be lost and with a 50% probability, 7 M will be earned.

With this simple example, our aim has been to show why compensation systems of financial sector executives, through stock options on holding companies, in the framework of a high-leveraged sector and state guarantees to savers' deposits, are behind the excessive risk taking leading to the financial crisis. These compensation systems have clearly led to making high-risk decisions for the companies, but with an individual interest for bankers. In situations such as the one described above, while business grows, executives benefit through the holding of assets, and when the situation is negative, the debtholders lose, and the tax-payers lose if governments have to contribute with funds to bailout failed businesses.

As evidence reinforcing the arguments deriving from their theoretical analysis, Bebchuck and Spamann (2009) describe the situation of the two leading United States banks in 2006: Citigroup and Bank of America.

Both entities were enormously leveraged, albeit not much more than others in the sector: both companies complied with the requirements of the Federal Reserve to consider that they were adequately capitalized. Towards the end of 2006, Citibank's main executive owned 1.6 million shares of the holding company, plus 1.1 million options with exercise prices between 32 and 54 dollars, whereas the closing price at the end of December for the Citibank stock was of USD 55.70.

In the case of Bank of America, its main executive held 2.9 million shares of the holding company, and 1.925 million options with exercise prices between 40 and 47, whereas the closing price of the stock on December 29 was of 53.39 USD.

We therefore see how both executives had a very significant investment in shares of their companies, but probably very little in bonds issued by them. As we have previously analyzed (see section b in the prior analysis), this simple fact already makes them prone to accepting high-risk transactions in their respective entities, because, with this system, they personally would obtain higher earnings in positive outcomes without having to face all the losses if the outcome were negative.

But in addition, the large amount of share options in their compensation system induced them further towards risky behavior. Since both executives had exercise prices of their options 20% lower than the value of the company stock, any losses of the financial entity entailing a loss of value of the stock higher than 20% would have no impact on the value of their options (which would then be worth zero). On the other hand, any positive outcome of risky businesses would indeed entail an immediate impact on a higher value of their stock options.

Therefore, as a conclusion we can state that an important part of the generation of the global financial crisis that started in 2007 has its roots in executive compensation systems applied in the financial sector, based on variable rewards and incentives with negative consequences, since they induced managers to engage in banking transactions with negative expected values.

6

Proposals to Improve Executive Compensation Systems at Large Companies in Spain

In prior sections of this paper we have analyzed how in recent decades, the relative weights of the various components of executive remuneration in large companies have changed, with remunerations based on options on the stock of the company or of a holding company acquiring increasing significance.

While this system is not, a priori and in itself, socially negative and may even bring about benefits in the management of companies, in that it aligns the goals of executives with those of the shareholders, we have seen how, under certain circumstances, they can lead to executives assuming excessive risks.

Therefore, and particularly in sectors which are especially sensitive for the economy as a whole, such as the financial sector or those industries that, due to their size or weight in the gross domestic product (GDP), may introduce a systemic risk in a country, there is a clear role for the public sector to play in determining the remuneration systems of executives. It is not our intention to plead that governments should put quantitative caps on the amounts that a company may pay its executives. However, under circumstances in which the insolvency of a company may generate a systemic impact in the economy, the systems used to determine these compensations could indeed be regulated. If there are banks that can make the economy collapse, thus requiring *ex post* public resources through intervention, the public sector should be able to introduce *ex ante* certain limits in the compensation systems.

In particular, and regarding especially the case of Spain, we consider that, in order to improve the current compensation systems for executives of large companies, improvements may be implemented in five areas:

- Increase the transparency of companies' remuneration decisions.
- Align the executives' remunerations with the risks and quality of investments.
- Disincentive exorbitant corporate golden parachutes for the Board of Directors.
- Disincentive the excessive weight of stock options in the executive remuneration system.
- Improve distribution and spread the use of stock options and layoff severance pays to the whole payroll.

a) Measures to increase transparency

The first and foremost would be to transform the recommendation of remuneration transparency into an obligation. For such purpose, the Spanish Corporations Act (*Ley de Sociedades Anónimas*) would need to be amended, in line with the guidelines contained in the Unified Code of Good Governance, to make transparency mandatory and not optional, as it is now⁴.

This transparency obligation on remunerations has been implemented in all G-7 countries, led by the USA⁵. Transparency has become mandatory even with respect to golden parachute clauses in countries such as the United Kingdom, France, the Netherlands and Australia. We therefore propose:

- To make mandatory for companies to create a Remunerations Committee, consisting of independent members⁶ which would propose to the Board of

4 In Spain, compensations in kind through options and shares is mandatorily subject, since 1999, to the prior authorization of the General Meeting of Shareholders, as provided under section 130 of the Spanish Corporations Act (*Ley de Sociedades Anónimas*). There is however no legislation applicable regulating the role of the General Meeting in relation to main compensations or to golden parachutes of high executives and company directors. The Code recommends for the Board to approve a detailed compensations policy, and to include it to a report on compensation policies to be submitted to the General Meeting of Shareholders. Likewise, it includes a number of Recommendations directly linked to compensations of Board members.

5 In the USA, the Sarbanes-Oxley Act (2002) modified rules on the operation of listed companies (SEC, Security Stock Exchange). The new regulations mandate the publication of all information relating to the remunerations of the executive director, financial director, the following 3 best paid directors and up to 3 additional workers who, while not being directors, receive a compensation higher than those. In the United Kingdom it is also for the shareholders to approve all long-term incentive schemes, including stock option schemes.

6 Not having financial interests other than those of the shareholders nor taking any strategic decisions in relation to the daily operations of the company.

Directors a remunerations policy for directors and high executives, the individual remuneration of executive directors and the basic contractual conditions of all of them⁷.

- The General Meeting will amend and, if appropriate, approve the Report of this Remunerations Committee. To make it a legal obligation for this vote to be a separate point in the agenda. The Report of the Remunerations Committee will contain all existing long-term incentive schemes (including stock options) from which the high executives benefit⁸.
- To extend the transparency principle to remunerations received individually by each member of the Board, mandatorily including such information in the Annual Accounts.
- To give preference in the access to public procurement or public guarantees to financial entities disclosing their corporate governance and corporate responsibility policies, the individual remunerations of their directors and executives, their liquidity and solvency ratios, following international comparability standards.

b) Measures to align the executives' pay with the risks and quality of investments

- Over and above the executives' base salaries, bonuses paid must be linked to the improvement in the value of the shares in the medium and long term (not only on the short term, as has been done to date)⁹. For example, a mechanism could be introduced whereby said extra remunerations would be deposited in a long-term fund (redeemable after 10 years), which would be increased with bonuses in times of good results, and would be reduced with penalties in times of losses. Guaranteed bonuses that are independent from the firm's profits are to be prohibited.

7 Said Appointments and Remunerations Committees already exist in almost all listed companies, but the percentage of independent members still does not exceed 50%, according to the 2007 Report of the Foundation for Financial Studies.

8 (Greenbury, 2000; Winter, 1999).

9 The Financial Stability Council has just recommended, after the G-20 meeting in Pittsburgh, that more than 50% of the executive retributions should be paid as firm stocks, which cannot be sold in the short-term, in order to create a more suitable behaviour in accordance with the firm interests in the long-run.

- In addition, incentives would need to be introduced to increase the correlation between individual and collective benefit: Make ratings dependent on the position of the financial entities in new rankings of ethical and socially responsible investment. For example, alongside the current rating system based in the probability of insolvency (AAA system), a complementary rating system could be introduced (“AAA-Responsible” system) taking into account also the social contribution of the investments carried out by the company in question (as well as other good governance and corporate responsibility elements).

c) Measures to disincentive exorbitant golden parachutes

In a majority of advanced countries, governments have decided to trust that incentives to increase the transparency of remunerations will end up limiting the salaries of executives and reducing the amount of their parachutes. However, given the persistence of exorbitant remunerations and parachutes in large multinational corporations, some countries have started to take specific steps. In addition to those mentioned in the paragraph above to impose an obligation of transparency and disclosure of remunerations, there are additional measures that can be taken to limit the amounts of parachutes:

- To condition the collection of parachute indemnities on the achievement of specific objectives fixed for the high executive, or on the growth (actual growth, not stock-market rises) of the company. This condition is mandatory in France after the 2007 reform.
- Payments made by the company pursuant to golden parachute clauses of executives dismissed may not be recorded as Deductible Expenses. In France this provision applies since 2007, and in the USA the above expenses are also non-deductible if “compensations paid exceed a reasonable amount” and if the executive “did not improve the performance of the company during his/her employment”.
- For those not wishing to condition golden parachutes to objectives or to the growth of the company, formulae would need to be introduced to extend this type of compensations to the rest of the workers. It does not appear reasonable for executives who support a reduction of severance pays for the payroll in case of layoff, to simultaneously guarantee for themselves compensations way beyond 33 or 45 days per year worked. We propose two different formulae.

- Calculating the percentage that the parachute makes in relation to the annual salary of the directive with a golden parachute clause, and forcing companies to increase the layoff severance pay in the same percentage for the rest of the workers¹⁰.
- Alternatively, companies may be forced to endow a “training and re-qualification” fund for their workers, with a value similar to that of excessive parachutes approved, available at the time of leaving the company and which will help workers obtain additional skills to find a new job.

d) Measures to disincentive the excessive weight of stock options in the executive remuneration system

The use of stock options benefits from tax incentives in Spain: the granting by a company of stock options to its employees is considered as remuneration in kind.

The valuation of this remuneration is the difference between the listing price of the stock on the date of exercise of the option, and the amount paid by the worker.

In addition, a 40% reduction in the income tax applies, provided certain conditions are met¹¹. Two recent judicial resolutions have questioned the above regulation: Supreme Court Judgments of 24 October, 2001 and 4 February, 2002.

Said judgments provide that stock options are salary in nature: The Supreme Court considers stock options as a “salary complement” and not as “salary in kind”; they are, according to the high court, a variable remuneration linked to the results of the company; and therefore they are included in the definition of salary contained in article 26 of the Workers’ Statute. We therefore propose a reform similar to that carried out in France since 2007:

10 Some proposals recommend endowing a complementary pensions fund instead of a complementary severance pays fund, in any event for an amount similar to the aggregate of golden parachutes.

11 Although in Spain we do not have caps on the amount of stock options that an executive may receive, there does exist a strong tax incentive to avoid speculation and hold them in time. Currently, under the tax reform of the IRPF (personal income tax) that entered into force on January 1, 2007, income arising from the exercise of stock options enjoy a 40% reduction (increased from 30%) in the event that: the option is exercised at least two years after the right was granted; and the purchase option is not granted annually. Moreover, when the shares are held for more than three years, the limit for the reduction is doubled.

- Stock options granted to high executives and Board members should contribute to the Social Security, at a rate of 28%.

e) Measures to incentivize the extension of stock options to workers and severance compensation in case of dismissal to the whole payroll

In the United States, the National Center for Employee Ownership actively fosters different formulae to increase the workers' participation in the ownership and results of companies. This has led to 10% of workers holding stock options in their compensation packages, as opposed to only 0.2% in Spain. Since these schemes increase the workers' bond with the firm and have a potentially positive effect on productivity, we propose:

- To increase the tax advantages enjoyed by general stock option schemes¹².
- To foster the granting to workers, for free or at reduced prices, of shares or equity interests in the capital of the company.
- To leave exempt from taxation revenues obtained by the worker from these securities, provided the following conditions are met:
 - Stock options must belong to the same company for which the worker is providing his/her services, or to a company in the same group.
 - Securities acquired should be held for at least three years and their granting will be conditioned on achieving the business objectives fixed.

12 These schemes already enjoy significant tax benefits following the tax reform of 2007, which could be increased in a forthcoming tax reform.

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