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CEO retirement compensation: Is inside debt excess compensation or a risk management tool?

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Abstract CEOs face constant scrutiny over their compensation packages. This scrutiny has only intensified amid discussions of CEO-to-employee pay ratios and income inequality nationwide. CEO retirement packages are criticized as camouflage compensation used to award excessive compensation to CEOs and were, prior to 2006, less transparent than they are now. Thanks to the transparent disclosures now required by the SEC, we have a better understanding of the types and amounts of compensation owed to CEOs after they depart or retire, termed *inside debt*. I investigate whether all CEO inside debt components share similar incentive effects and offers some thoughts on how companies might structure these packages to be most effective. I discuss the structure and incentive effects of the two primary components of inside debt: deferred compensation and supplemental executive retirement plans (SERPs). I explain why inside debt, particularly CEO SERPs, may actually help companies manage firm risk. Finally, I outline the best ways to structure inside debt so that it functions as a resource to manage firm risk and foster a long-term perspective rather than mirroring the incentive effect of equity, increasing risk, and encouraging a myopic focus.

1. The agency problem

The structure of CEO compensation has been debated since the formation of the first corporations, which, since they separate ownership from management,

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introduce an inherent agency problem. Owners no longer manage the firm, and managers of the firm are hired by the owners, through the board, but do not own the firm. Owners entrust management of the firm to agents whose motivations differ from their own. This agency problem only grows more severe with diffuse ownership. Agency theorists have written about this conflict since at least the first half of the 20th century (e.g., Berle & Gardiner, 1932; Jensen & Meckling, 1976).

The solution most commonly discussed is to grant ownership—such as stock options and other equity grants—to managers with the purpose of aligning their incentives with the incentives of the owners. If incentives are aligned, then there is less concern that managers will act in their own best interest rather than in the interest of owners. Most of what is written about CEO compensation, whether in media or in academe, is focused on equity ownership to alleviate the agency conflict with stockholders. However, equity incentives, particularly stock options, also provide incentives for managers to increase risk. This incentive, combined with a corporate culture obsessed with quarter-to-quarter results, has caused some concern about excessive risk taking, especially in light of recent bank failures during and following the U.S. recession. The other side of the agency problem that historically has received less attention but now is starting to receive more is aligning the incentives of managers with not only stockholders but also debt holders. The majority of capital raised in our economy is through debt offerings, not equity. This is where retirement compensation can be used as a tool to alleviate agency conflict.

Compensation that CEOs are to receive at retirement is termed *inside debt*: payments that are owed to the CEO that are similar to debt payments. Historically, retirement compensation has been granted by boards based on industry or societal standards, with little thought given to the incentive effects. Critics of retirement packages have called out retirement compensation as excessive because they believe that it is not tied to performance. Recent research showed that not only can retirement compensation help alleviate agency conflicts with debtholders, but also serve as a valuable tool to manage CEO risk taking.

In this article, I discuss the theoretical role of inside debt as part of the compensation package, the difference between the two components of inside debt—supplemental executive retirement plans (SERPs) and deferred compensation—and draw conclusions informed by new research related to inside debt. I clarify the incentive benefits for these retirement packages in hopes that future debates around CEO retirement compensation will include discussion of the incentive effects in addition to the monetary amounts. I also offer recommendations as to the types of companies that might benefit from including inside debt in their compensation packages and how it can be structured to increase effectiveness.

2. What is CEO inside debt?

Public discontent with CEO pay packages is moving beyond annual compensation to retirement compensation. This discontent seems particularly strong in light of growing political concern about U.S. wealth and income inequality. An October 3, 2017 article in the *Los Angeles Times* specifically addressed the disparity between the average worker and CEO retirement plan structures and amounts. The article cited data from Willis Towers Watson that said in 1998, about half of private-sector employees were offered a defined-benefit pension plan; by 2015, only 5% of employees had access to such a plan (Lazarus, 2017). This is in contrast with the 28% of S&P 1500 CEOs who have defined benefit plans and 58% that have some form of long-term compensation that they will receive at or after retirement. The ratio of CEO salary to average employee salary is a metric that has received widespread media, political, and regulator attention. Comparing CEO pay to average worker pay resulted in a ratio of 44 to 1 in 1980, a difference that grew to 344 to 1 by 2007. The excess is even more pronounced when comparing retirement balances. For example, Gregg Steinhafel stepped down as CEO of Target in May 2014 with a retirement package valued at $27.7 million, which is 615 times larger than the average 401(k) value of $45,000 for a Target employee (Hymowitz & Collins, 2015). A 2016 study by The Institute for Policy Studies showed that the sum of the 100 largest CEO company retirement funds was $4.7 billion. This is equal to the entire retirement savings of 41% of Americans with the lowest levels of retirement savings (IPS, 2016). As companies and boards work to explain the divide between CEO and average worker salaries, they now need to consider retirement balances as well.

Academics have also recently paid more attention to compensation received by CEOs after they exit the firm. Inside debt is the term used in academic research for post-employment or retirement pay received by executives. The first of its two components, SERPs, are defined-benefit pension plans granted to executives; the second, deferred