Far from retiring

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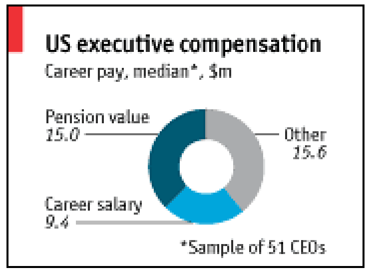
Pensions should be brought into the debate about bosses' pay and performance

THERE has been a welcome shift in bosses' pay away from stock options, which are often tenuously related to performance, and towards discretionary bonuses, which are set by board pay committees. In 2004 the award of stock options to American bosses fell for the second year running, while bonuses increased on average by over 20%. But one element of compensation has been largely overlooked in the debate about how best to align pay and performance—pensions.



Most studies ignore these because the figures are not generally available, and because there is a feeling that pensions do not motivate in quite the same way as cash “straight into the bank at the end of the month”. Pensions, though, are in reality just deferred pay, and the incentive effect of performance-related pay would surely be diluted if the recipient is guaranteed a post-retirement income of several million dollars a year.

A remarkable new study by Lucian Bebchuk and Robert J. Jackson of the Harvard Law School shows how often the sums involved are indeed of this magnitude. The authors looked at the extent of the undisclosed pensions of a cross-section of American bosses with so-called “defined-benefit” schemes, ones whose pay-out is related to the individual's final salary and years of service. The ultimate actuarial value of such schemes is hard to determine until the recipient nears retirement age. Hence the authors took a sample of American bosses who had recently retired, or who were about to.

The amounts involved are not insignificant. The value of the pension plan of Hank McKinnell, the chief executive of Pfizer, is well over $70m, more than the total compensation he has received during his years as head of the company. This is still a small percentage of Pfizer's profits, but at Black & Decker the value at the end of 2003 of the pension of Nolan Archibald, its chief executive, was equal to about 1% of the firm's total market value. This month, United Airlines said that ditching its defined-benefit pension plan could save it $645m a year and help keep it from bankruptcy.

The authors also found a huge variation in the size of bosses' pensions. The actuarial value of their sample varied from $3.3m to $73.4m (the latter for Lee Raymond of Exxon Mobil who will receive $5.76m every year of his retirement until he dies). About one-third of the chief executives had no disclosed pension benefits at all. But some had what amounted to much the same thing. Henry Silverman of Cendant, for example, is to receive consulting fees on his departure worth about $1m a year for the rest of his life. Dennis Kozlowski, the former boss of Tyco currently on trial for fraud, deferred cash bonuses of $18.7m that he was due to receive in 2000.

Messrs Bebchuk and Jackson rightly argue that the lack of disclosure of pensions and other forms of “stealth compensation” leads to “significant overestimation of the extent to which executive pay is linked to performance”. Without their pensions, the non-variable element of the compensation packages of the authors' sample (ie, the lump not affected by performance, in most cases the basic salary) is 15% of the total; including pensions that rises to 39%.

To bring pay more into line with performance and to gauge the true level of risk, investors need to know the value not only of stock options and bonuses granted to top executives, but also of their pensions. To find that out at the moment shareholders need the skills of Harvard research assistants and a generous budget. This should not be the case.