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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.
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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

compensation, is earned compensation to be paid at a later date. These components are referred to as inside debt because they are amounts owed—that is, debt, by the firm to the CEO, to be paid in the future. They are termed supplemental because they exceed the amounts covered by The Employee Retirement Income Security Act of 1974 (ERISA) regulations. Executive retirement packages are not governed by ERISA and have unique characteristics that differ from average employee retirement packages as well as from other components of CEO compensation. Because these retirement packages are not regulated by ERISA, they tend to be quite large. For example, the media reported that former ExxonMobil Chairman and CEO Lee Raymond received a retirement package estimated to be worth close to $400 million subsequent to his retirement in 2005 (Mouawad, 2006). The entire $400 million was not related to his retirement; however, he did receive a $98 million lump sum payment of his pension when he retired (SEC, 2006). Current Secretary of State and most recent retiring Exxon CEO, Rex Tillerson, has a pension valued at $69 million, also available in lump sum payment form. When the CEO of Bank of America, Ken Lewis, announced his plans to step down at the end of 2009, *The Wall Street Journal* valued his retirement package at $69.7 million (Solomon & Fitzpatrick, 2009). Yet, public pressure to limit CEO pay has increased, especially in light of bonuses received by executives at failing banks during the great recession. The U.S. Treasury ordered Ken Lewis to forego his salary and bonus for 2009, in part due to the magnitude of his retirement package. Although Bank of America received TARP funds, the Treasury could not access retirement packages negotiated prior to receipt of the funds.

The last decade has seen a rise in attention paid to CEO retirement packages primarily because, prior to 2006, retirement arrangements and balances were not clearly disclosed to the public. The SEC now mandates disclosures concerning both forms of CEO inside debt. The new mandate follows the initiation in 2005 of required corporate disclosures of risk factors. Research shows that these risk factors do correlate with risk and are valuable disclosures for investors (Campbell, Chen, Dhaliwal, Lu, & Steele, 2014). The SEC's objective has not only been to increase the disclosure of monetary amounts but also to require qualitative disclosures addressing compensation strategies and goals and their relation to firm risk. These disclosures, most often made in annual proxy filings, provide a link between firm benchmarks or objectives and executive compensation methods. In December 2009, the SEC issued a release discussing enhanced disclosures concerning risk, compensation, and corporate governance. The intent of the new disclosures is to provide users of this information with not only the context of compensation as it relates to company financial performance but also the compensation itself and its effect on firm risk. The release (SEC, 2009) outlined several specific objectives, including disclosures about "the relationship of a company's compensation policies and practices to risk management" as well as "board leadership structure and the board's role in risk oversight."

The disclosures reflect growing concern about excessive risk taking by executives and its impact on stakeholders. If compensation structures affect management choices and these choices affect firm characteristics, then firms and stakeholders must have an understanding of how CEO compensation structures impact firm risk. Furthermore, these disclosures give companies an opportunity to explain compensation paid to executives and provide justification for the incentive design.

While concerns over excess pay may be valid, it is also critically important to understand the components of CEO pay and the incentives they provide. For example, equity compensation continues to be used to align management incentives with investor incentives. However, some evidence suggests that the link may not be as strong as some believe (Lorsch & Khurana, 2010). Those interested in understanding CEO compensation should understand other forms of CEO compensation such as inside debt. As of 2016, the inside debt component of CEO compensation packages (for which the component is present) averages $9.5 million in value, with the largest balance just over $200 million. Generally, these amounts are promised to be paid in the future as long as the company remains solvent. Early research on inside debt suggests that this form of compensation may reduce excessive risk taking and foster a long-term focus. Alternatively, some argued that, because of its structure, inside debt is not an effective strategy for meeting these goals (Jackson & Honigsberg, 2014).

3. The role of inside debt

Debt holders are critical stakeholders in firms, yet their interests often are overlooked. In 2006, U.S. corporations raised $2.6 trillion in new external capital, and $2.5 trillion was debt financing (Armstrong, Guay, & Weber, 2010). This creates a significant agency problem for most corporations. CEOs are primarily compensated with equity (e.g., stock, restricted stock, options) and are thus motivated to maximize equity values. Generally, this

involves taking risks, sometimes excessive, that may not be in the best interest of debtholders or other stakeholders. The academic literature suggests that a firm can eliminate most of the agency costs of debt by having the manager hold equal portions of compensation related to debt and equity (Jensen & Meckling, 1976). This kind of compensation eliminates the incentive to base decisions on stock price alone. In other words, if managers were compensated with a promise to be paid in the future (like debt) as well as equity, then they would be subject to the same concerns as the firm's debtholders because these managers also want to be paid in the future. This creates a disincentive to pursue excessive risk because solvency and adequate liquidity are necessary for the CEO and other debtholders to be paid. Inside debt balances have grown at faster rates than annual salary, likely due to social pressures focused on CEO salaries. Table 1 provides an analysis of the growth of inside debt balances as compared to the growth of annual salary from 2007—2016, the most recent fiscal year for which ExecuComp (a database providing compensation information on current and former member companies of the S&P 1500) provided complete data. Table 2 presents a summary of the largest inside debt balances as well as the largest SERP and deferred compensation balances as of 2016. Table 1 shows that annual salaries grew 19% during this time period while inside debt balances grew 24% and SERPs 55%. Just over half (58%) of the CEOs in this sample have some form of inside debt. Specifically, 51% of CEOs have some form of deferred compensation, while only 28% of CEOs have a SERP.

CEO inside debt can act as a lever by which boards of directors can moderate risky CEO investment choices, but investors, boards of directors, and compensation committees must understand how they should be structured to serve this role best. Both components of inside debt are examined individually in Sections 3.1.—3.2.

Table 1. Analysis of salary vs. inside debt growth

	2007	2016	% Change
Average annual salary*	842	1,002	19%
Average inside debt balance*	7,703	9,584	24%
Average SERP balance#	5,947	9,197	55%
Average deferred comp balance	4,818	5,683	18%

Provides an analysis of the change in average salary, average inside debt balances, average SERP balances, and average deferred compensation balances from 2007 to 2016, the most recent fiscal year with comprehensive data. Dollar amounts are in thousands.

* To be included in the analysis, CEOs had to be listed on ExecuComp and had to have an inside debt balance.

Calculated for CEOs with SERPs. CEOs without SERPs were excluded from the average.

3.1. Supplemental executive retirement plans (SERPs)

Companies may offer two primary types of retirement plans to their executives: qualified and/or nonqualified plans. Qualified plans are regulated by ERISA and the Internal Revenue Code. These plans are the same plans offered to most employees within a company (e.g., 401(k)) and offer certain tax advantages. They are regulated by ERISA to provide protection of deferred compensation and fringe benefits for common employees (Kennedy, 2002). The total level of retirement funds contributed to qualified plans cannot exceed regulated amounts. These amounts generally are protected in the event of bankruptcy. In other words, most of the retirement plans with which the public is familiar and that are available to most employees are qualified. The employee can contribute pre-tax amounts to the plan, the employer can match those amounts, and the employer gets a tax deduction for matching. However, because these amounts are limited, companies also use structured nonqualified executive compensation plans such as SERPs to enhance CEO compensation.

A SERP does not receive the preferential tax treatment enjoyed by the qualified plans. However, there is no limit to the amount that may be accumulated within the SERP. Under a nonqualified plan, or SERP, the employee—generally a high-level executive—does not incur a tax liability for amounts contributed to the SERP, but the employer does not receive a tax deduction until distribution. Once the cash is distributed, the employee is taxed on the distributed amount. However, all deferred amounts must be unavailable to the employee or subject to substantial risk of loss or forfeiture; otherwise, the amounts become immediately taxable to the employee (Kennedy, 2002). This risk of loss is fundamental to the incentive effect of this form of compensation. The level of protection for SERPs is very different from that of a qualified plan. Generally, under a qualified plan, amounts earned by employees are set aside and protected in the event of a liquidity crisis or bankruptcy. Since SERPs are not protected in the event of a liquidity crisis or bankruptcy, they are similar to debt. The CEO, like a debtholder, will receive payment only if the company is solvent.

Table 2. Largest inside debt, SERP, and deferred compensation balances as of 2016

Panel A: Largest inside debt balances, 2016
Provides a listing of the top 10 largest balances for inside debt for 2016, the most recent fiscal year available in ExecuComp. Dollar amounts are in thousands.

CEO	Company	Age	CEO Start Date	Salary	SERP Balance	Deferred Comp Balance	Inside Debt Balance
Richard B. Handler	Leucadia National	55	3/1/2013	1,000	259	201,810	202,069
David M. Cote, J.D.	Honeywell International	63	7/1/2002	1,890	58,880	136,202	195,082
Paul C. Saville	NVR	60	7/1/2005	1,566	0	178,015	178,015
John H. Hammergren	McKesson	58	4/1/2001	1,680	114,000	34,203	148,203
Larry J. Merlo	CVS Caremark	60	3/1/2011	1,630	43,743	80,841	124,585
Michael F. Neidorff	Centene Corp.	72	5/1/1996	1,200	0	110,078	110,078
John R. Strangfeld, Jr.	Prudential Financial	62	1/1/2008	1,400	82,318	11,170	93,489
Randall L. Stephenson	AT&T Inc	55	5/9/2007	1,791	54,031	38,888	92,919
Ian C. Read	Pfizer Inc	62	12/5/2010	1,905	13,946	77,895	91,841
Jeffrey R. Immelt	General Electric	59	1/1/2001	3,800	81,659	9,856	91,515

Panel B: Largest SERP balances, 2016
Provides a listing of the top 10 largest balances for SERPs for 2016, the most recent fiscal year available in ExecuComp. Dollar amounts are in thousands.

CEO	Company	Age	CEO Start Date	Salary	SERP Balance	Deferred Comp Balance	Inside Debt Balance
John H. Hammergren	McKesson	58	4/1/2001	1,680	114,000	34,203	148,203
John Robert Strangfeld, Jr.	Prudential Financial	62	1/1/2008	1,400	82,318	11,170	93,488
Jeffrey R. Immelt	General Electric	59	1/1/2001	3,800	81,659	9,856	91,515
Rex W. Tillerson	Exxon Mobil	64	1/1/2006	3,167	69,104	2,243	71,347
David M. Cote, J.D.	Honeywell Intl.	63	7/1/2002	1,890	58,880	136,202	195,082
Randall L. Stephenson	AT&T Inc	55	5/9/2007	1,791	54,031	38,888	92,919
Daniel P. Amos	Aflac	64	1/1/1990	1,441	53,103	6,194	59,297
John B. Hess	Hess	62	1/1/1983	1,500	52,513	0	52,513
Marillyn A. Hewson	Lockheed Martin	62	1/1/2013	1,634	48,124	39,770	87,895
Wayne T. Smith	Community Health	70	4/1/1997	1,600	46,321	7,877	54,199

Panel C: Largest deferred compensation, 2016
Provides a listing of the top 10 largest balances for deferred compensation for 2016, the most recent fiscal year available in ExecuComp. Dollar amounts are in thousands.

CEO	Company	Age	CEO Start Date	Salary	SERP Balance	Deferred Comp Balance	Inside Debt Balance
Richard B. Handler	Leucadia National	55	3/1/2013	1,000	259	201,810	202,069
Paul C. Saville	NVR	60	7/1/2005	1,566	0	178,015	178,015
David M. Cote, J.D.	Honeywell International	63	7/1/2002	1,890	58,880	136,202	195,082
Michael F. Neidorff	Centene Corp.	72	5/1/1996	1,200	0	110,078	110,078
Richard J. Campo	Camden Property	61	5/1/1993	517	0	90,946	90,946
Harold Messmer, Jr.	Robert Half Intl Inc	70	1/1/1987	525	0	82,789	82,789
Larry J. Merlo	CVS Caremark	60	3/1/2011	1,630	43,743	80,841	124,585
Ian C. Read	Pfizer Inc	62	12/5/2010	1,905	13,946	77,895	91,841
Hamid R. Moghadam	Prologis Inc	59	6/1/2011	1,000	0	73,981	73,981
C. Douglas McMillon	Wal-Mart Stores	51	2/1/2014	1,278	0	73,413	73,413

3.2. Deferred compensation

Deferred compensation, the other component of inside debt, shares some characteristics with SERPs. This is another form of nonqualified compensation that is subject to similar tax regulations as SERPs (i.e., it is not protected or guaranteed). In this case, the compensation is earned, but the payment deferred. The compensation committee can choose to have a specific amount or percentage of the CEO's compensation deferred, or the CEO can choose to defer a portion of his or her earnings in a given year. One unique attribute of deferred compensation is that the deferred amounts can be invested in or have their growth tied to a number of portfolio options, including various funds or indexes as well as the firm's own stock. The company might also promise a fixed rate of return. Deferred compensation can be subject to volatility and risk characteristics similar to equity compensation since it is usually invested in or linked to a stock price in some way whereas SERPs grow at predictable rates, usually as a function of salary and time. In addition, the balance is almost always paid as a lump sum at retirement, not as an annuity, and deferred compensation may be withdrawn prior to retirement.

The structural differences between SERPs and deferred compensation cause them to operate differently as incentives. When deferred compensation growth is tied to stock price, it incentivizes similar risk preferences as equity compensation and is thus ineffective in reducing agency conflicts with debtholders. Furthermore, the prevalence of lump sum payments reduces the incentive to decrease risk, as the executive will not have to wait to receive payment in the future as a debtholder would.

4. What impact does inside debt actually have on the CEO?

Corporations have not required CEOs to invest in debt instruments used by the firm; however, firms may be using inside debt as a debt-like instrument to align CEO incentives with those of debt holders. If inside debt is structured as a long-term agreement for the CEO to receive an annuity stream in the future, then the plan is very similar to debt (i.e., the company owes the CEO payments in the future just as the firm owes bondholders payments in the future). If the annuity is subject to forfeiture in the event of bankruptcy, then the CEO will manage investment policy to ensure the stability of the firm. If the CEO has a nontrivial amount of personal wealth at risk that will be paid in retirement, there is an incentive to think long-term, to avoid excessive risk, and to manage cash appropriately.

Some studies offer evidence to support this notion that SERPs do change CEO incentives and reduce agency costs (Sundaram & Yermack, 2007). Early work using a sample of S&P 500 firms showed that as the amount of CEO inside debt increases, common measures of firm risk decrease (Cassell, Huang, Sanchez, & Stuart, 2012; Sundaram & Yermack, 2007). They provide evidence that as inside debt increases as a relative percentage of net worth, CEOs spend less on R&D expenditures, increase liquidity of the firm, and seek strategies to diversify the firm. All of these policies move toward lower firm risk. Research also shows that the public markets are paying attention to the level of CEO inside debt. There were no public disclosures of CEO inside debt balances until the end of 2006. Once stockholders and bondholders were provided with this information through proxy statements, stock and bond prices changed. As expected, bond prices increased and stock prices and volatility decreased (Wei & Yermack, 2011). These findings are consistent with agency theory. Bondholders were now more comfortable that management incentives were aligned with their incentives. Alternatively, stock prices dropped as stockholders realized that management may be incentivized to take less risk.

Research also supports the notion that SERPs and deferred compensation have different incentive effects. Choy, Lin, and Officer (2014) studied a sample of companies that chose to freeze their defined benefit pension plans and found that firm risk increased according to a number of different measures. Using an analysis of corporate debt contracts, Anantharaman, Fang, and Gong (2014) measured the impact of SERPs and deferred compensation individually and found that SERPs are associated with less risk (as measured by lower promised yield and fewer debt covenants) but deferred compensation is not. These more recent articles evidenced that how inside debt is structured will affect how it performs as an incentive.

4.1. CEO decision making and the difference between SERPs and deferred compensation

CEOs with inside debt have wealth that is promised to them as long as the firm does not enter bankruptcy. In addition, these CEOs still have equity in the firm, and the value of this equity largely depends on the performance of the firm as a result of investment choices made by the CEO,

often maximized by increasing risk. Kahneman and Tversky (1979, p. 263) found that "people underweight outcomes that are merely probable in comparison with outcomes that are obtained with certainty"—the certainty effect of prospect theory. Prospect theory explains what we see in the research: CEOs will underweight the outcomes associated with the equity and overweight the certainty of the inside debt. That is to say that CEOs will act to manage the firm conservatively for the certainty of a large inside debt value even if that results in not maximizing the value of their own equity holdings.

In general, inside debt is thought of as an unfunded, unguaranteed annuity to be paid throughout retirement. If the amount is unfunded and unguaranteed, the inside debt payments are subject to the performance of the firm at the time of the CEO's retirement as well as future performance under a new CEO. If the firm enters bankruptcy, the CEO loses all right to the inside debt. For this reason, it is in the best interest of the CEO to carefully consider firm investment decisions, ensure future liquidity, and think critically about long-term performance. This maximizes the probability of full payment.

The differences between SERPs and deferred compensation affect the actual incentive delivered as well as the horizon of the compensation. The longest timeline for most deferred compensation arrangements is a lump sum upon retirement. The horizon could be much shorter if the deferred compensation is withdrawn prior to retirement. This shorter timeline increases the probability that the CEO will actually receive this compensation and reduces its similarity to debt. Once the funds are held by the executive, they are not subject to future firm performance, whether that performance is influenced by the current CEO or by a new CEO. The CEO with the option to receive his or her payment quickly upon retirement or before may be less concerned about conservatively managing the firm to avoid bankruptcy or loss. He or she does not have to worry about future firm performance and has much greater control over the profitability and liquidity of the firm at the time that the benefit is paid; therefore, he or she is able to take risks to maximize personal stock and option values knowing that the compensation is relatively safe. Furthermore, deferred compensation growth often is tied to firm stock price or some other performance metric, further diminishing its efficacy in moderating risk. To the extent that the growth is tied to a performance metric, it becomes an incentive compensation not completely dissimilar from equity (Jackson & Honigsberg, 2014). For these reasons, properly structured SERPs, not deferred compensation, are actually the component of inside debt that is responsible for the benefit of moderating firm risk.

4.2. When SERPs make sense

If SERP characteristics more closely reflect debt characteristics and thus SERPs are the primary driver of the benefits of inside debt, it is also likely that the setting in which SERPs exist has an impact on the incentive they provide. In particular, for typical characteristics of SERPs (long-term in duration and some risk of loss) to have an impact on measures of firm risk, the firm must be in a setting that is subject to these characteristics. It is likely that the association between SERPs and measures of firm risk will be stronger for firms that operate in industries for which long-term decisions—such as R&D investment and capital expenditures—have a greater impact and where some risk of loss exists.

If a CEO has a large SERP but the firm has very little or no significant debt, then the likelihood of bankruptcy is remote. Perhaps SERPs may constitute excessive compensation in this situation. The threat that a company could go bankrupt must exist in order for a SERP to provide the incentive effect of reducing risk. Furthermore, if the firm has no significant debtholders, then agency costs are minimal and granting SERPs may not be necessary. In addition, the incentive effects of SERPs are likely to be strongest when a CEO faces long-term investment choices. Long-term projects are likely to influence the resources of the firm over a period of time equivalent to the term of the SERP. Furthermore, the effects of long-term initiatives—good or bad—are likely to persist into the future, possibly even into the retirement period of the CEO. This is precisely when a SERP would be most relevant. The probability of receiving full payment of the SERP likely affects the risk tolerance of the CEO when considering investing in a long-term project, including implications for future cash flow.

It is also possible that differences within the SERP—specifically, any way in which the balance is protected—may affect its effectiveness as inside debt. If SERP payments are made in the form of a lump sum or the payments are protected by a rabbi or secular trust, then the SERP is better protected from loss than if it took the form of an annuity. A CEO who has the option to take a lump sum at retirement perceives a greater probability that he or she will actually receive the funds as opposed to the CEO who receives his or her payments over the remainder of his or her life. The funds are immediately available for personal use and are not subject to future firm performance primarily

controlled by a new CEO. This additional protection or shelter of the SERP may moderate the association between CEO SERPs and firm risk.

Interested in this possibility, I analyzed SERP payment information from the first company proxy statements and CEO contracts made publicly available for the December 31, 2006, year end. For all S&P 500 firms that had a SERP balance, I read each proxy and exhibit to determine the form of payment for the SERP and also searched for any mention of trusts used to protect SERP balances. I found that roughly 47% of the SERPs had some form of protection. Within the group of protected SERPs, 49% were protected by an option to receive a lump sum payment, 38% were protected by a lump sum payment, 7.5% were protected by a rabbi trust, and 5.5% were protected by a secular trust.

5. Excessive compensation or a moderator of firm risk?

While I acknowledge concerns about excessive CEO compensation, my goal in this discussion is not to address these concerns but to increase understanding of inside debt as an incentive and of its potential use as a risk management tool. While the research on the role of inside debt is fairly new compared to other areas of compensation research, we do have some clear indications that inside debt, structured properly, can be effective in moderating firm risk. However, to achieve this effect, it must be structured like debt, with limited protections and similar payoff periods. Though deferred compensation does not seem to be an effective incentive tool to moderate firm risk, there nonetheless seems to be greater public hostility against SERPs. When CEOs appear to be the only individuals who still have access to defined benefit pension plans, this hostility may seem a natural result. However, companies substituting deferred compensation for SERPs may face the unintended consequence of altering the firm risk profile. Researchers, compensation consultants, and compensation committees must continue to investigate the specific components of compensation as effective tools to produce desired outcomes. Firm risk and excessive risk taking by executives is still a concern among market participants. Calls to reduce executive compensation may be appropriate, but a targeted understanding of the incentive each form of compensation provides can assist compensation consultants and compensation committee members in developing compensation packages that lead to desired outcomes both from a firm financial and firm risk perspective.

5.1. How can inside debt be used effectively?

A majority of Americans (74%) believe CEOs are overcompensated when compared to the average worker (Larcker, Donatiello, & Tayan, 2016). The findings, reported in a study conducted by Stanford, are based on questions asked about annual compensation. Public opinion is likely to be even worse when retirement compensation enters the discussion because the disparity is greater. Boards, compensation committees, and consultants are quickly finding that they need to provide justification for retirement packages offered to CEOs. Yet companies, investors, and regulators need to consider the incentive effect of certain forms of inside debt when discussing these plans. Specifically, since two of the primary concerns about public corporations today relate to risk and lack of long-term perspective, companies, investors, and regulators should address the extent to which inside debt can be used as a lever to control risk and to motivate a long-term horizon for CEO decision making. The public discontent with CEO compensation is likely related to recent corporate failures resulting from excessive risk taking and a myopic, quarter-to-quarter focus. Furthermore, amid growing momentum for corporations to be responsible if not socially active, properly structured inside debt can address investor and director concerns. The following recommendations are provided for compensation committees and businesses.

5.2. What type of business can benefit most from incorporating inside debt into the compensation structure?

5.2.1. Companies with debt in the capital structure

Companies that have debtholders should consider using SERPs to help alleviate agency conflicts between stockholders and debtholders. As a disciplining mechanism, debt forces companies to abide by debt covenants and maintain sufficient capital and it provides a tax break due to interest expense incurred. In the same way, a SERP can serve as a disciplining mechanism for a CEO. By tying retirement compensation to long-term liquidity of the firm, boards incentivize long-term thinking from CEOs. Specifically, CEOs with a balanced compensation structure that includes equity and a SERP will more effectively balance the firm's short-term interests against its long-term interests. For example, without a long-term incentive, CEOs may not properly invest in research and development or other long-term investments in order to meet quarterly earnings targets. If provided a proper

long-term incentive, CEOs may choose to make the investment in research and development that returns the greatest long-term value. Coupling a healthy amount of debt with a SERP in the CEO compensation package can provide the company with additional discipline and a long-term perspective.

5.2.2. Companies with large institutional holdings—particularly dedicated institutional investors with a long time horizon

Institutional investing strategies vary, with some institutions tending to move in and out of investment positions quickly and others making dedicated investments and tending to hold positions for a longer horizon (Bushee & Noe, 2000). Almost half (46%) the entire stock market is owned by retirement accounts, nonprofits, and insurance companies, all largely managed through institutions (Rosenthal & Austin, 2016). The primary investment goal for these groups is sustained long-term value. They are not concerned about profiting from daily or quarterly volatility. These dedicated institutions likely appreciate the long-term focus that inside debt incentivizes in executives.

5.2.3. Companies with long-term sustainability or corporate social responsibility goals

Strategically, one group that may see the greatest benefit from using long-term compensation such as SERPs consists of companies pursuing sustainability or corporate social responsibility (CSR) efforts. Corporate boards should consider these goals when deciding whether to grant inside debt or when determining the structure of such compensation. This may be of even greater importance given increased institutional pressure for companies to invest in sustainability initiatives (e.g., BlackRock CEO Larry Fink charged CEOs to think about the societal implications of their decisions and develop a long-term perspective). Deferred compensation growth can be tied to the achievement of sustainability targets. Many CSR initiatives—such as workplace diversity, environmental concerns, and employee concerns—are long-term in nature. Tying the achievement of these goals to a form of long-term compensation seems appropriate. Certain sustainability initiatives require substantial investment initially but result in long-term savings. Inside debt may provide the extra incentive to make current sacrifices to achieve long-term results.

5.2.4. Companies with significant cybersecurity or data breach exposure

Data breaches are a growing risk for companies—particularly companies that have private consumer information—and the amount of private information that is stored digitally continues to increase. In recent years, there have been data breaches at large companies such as Equifax, Yahoo, and JP Morgan Chase that affected hundreds of millions of customers if not billions, as in Yahoo's case. Guarding against a data breach is similar to acquiring insurance for an asset. While the risk or cost of a breach may be great, it is difficult to assess the return on the investment. It is an investment made to prevent negative returns, not necessarily provide positive returns. For a CEO who is largely compensated with options, this is probably not an attractive investment. As a result, these companies may shirk their responsibility to customers and business partners by not considering long-term consequences. Inside debt compensation could incentivize CEOs to keep an eye on long-term risks such as data rather than risking security tradeoffs for short-term profits. Data breaches will affect long-term cash flow, which could threaten future CEO retirement payments. This form of compensation could be uniquely effective in addressing this new risk.

5.3. How should inside debt be structured so that it is most effective?

5.3.1. Inside debt should be paid as an annuity

Compensation committees and compensation consultants should work diligently to structure both components of inside debt to meet the desired incentive effect, which is to moderate risk and foster a long-term perspective. The first step is to structure inside debt so that it is paid as an annuity. This mirrors debt payment structures and provides the greatest incentive alignment between debtholders and CEOs. Both stakeholders are thus concerned about protecting future cash flows. If inside debt balances are available in lump sum form, then they can be accessed upon retirement, if not earlier. Inside debt balances paid in any form should foster a longer-term perspective than quarter-to-quarter but will not mirror debt payments until payments are spread over a longer time horizon. This longer horizon is also likely more comparable to the time horizon for dedicated institutions and various sustainability initiatives.

5.3.2. Inside debt should not be protected by a trust

Inside debt balances—particularly SERPs—are often protected by trusts. By placing future payments in a trust, companies remove some of the risk of loss. The amount of risk reduction depends on the structure of

the trust. If SERP balances are placed in a secular trust and protected completely, then there are negative tax consequences for the CEO; however, the CEO will still receive the payments even in the event of bankruptcy. Since it is risk of loss that creates the incentive, inside debt will not motivate CEOs to value long-term profitability and cash flow if their retirement payments are protected by a trust that shields these payments. To align CEO incentives with those of debtholders, the payments should be subject to the future viability of the firm just as debtholders' payments are. If future cash flow becomes unavailable to the debtholders due to a liquidity crisis, then it should be unavailable to the CEO as well.

5.3.3. Inside debt growth rates should not be tied to stock price

If SERPs have well-defined growth rates, often a function of salary and time served, the structure poses no real threat to the incentive. At times, deferred compensation growth rates are tied to company stock price or some other market or return metric. This undermines the effectiveness of using deferred compensation to foster a long-term perspective and further enhances a CEOs focus on short-term market returns. For inside debt to incentivize a long-term perspective and moderate risk, growth of this compensation should not be tied to volatile stock returns—particularly the company's own stock. Growth of inside debt should be tied to long-term viability and liquidity. Companies may balance incentive compensation between short-term goals and long-term goals. For instance, compensation committees currently use equity compensation to motivate relatively short-term performance. They could continue this, but tie deferred compensation growth to long-term goals. This strategy might keep a CEO from cutting valuable R&D in order to meet a quarterly earnings target, and it mediates agency conflicts by providing a balanced compensation structure.

5.3.4. Compensation committees need to address CEO hedging of compensation risk

Another growing trend that compensation committees should consider is the hedging of compensation risk by executives (Dye & Sridhar, 2016). Executives enter into hedging transactions with banks in order to reduce the risks to their compensation. As it relates to inside debt, a CEO could enter into a contract that eliminates the risk associated with inside debt or just sell the future payments in return for a lump sum payment. Hedging compensation reduces or eliminates incentive effects for all forms of compensation. To protect the intended incentives, compensation committees should not allow executives to enter these agreements. Inside debt can be a classic incentive structure to hedge against. Even if structural precautions are taken so that inside debt is not protected by trusts and payments are annuities, the door is still open for executives to limit their risk by selling future payments to a financial institution in return for a current lump sum, albeit at a discount. It may be beneficial for the SEC to adopt regulations prohibiting hedging risks related to compensation. Compensation packages are structured to incentivize based on certain risks. CEOs should not be able to enter into a transaction with a bank simply to eliminate the intended incentive effects of their compensation.

6. Summary

Public concern about CEO pay—fueled by CEO-employee pay ratios for annual compensation—is now focusing on CEO-employee retirement ratios. Companies now face the challenge of justifying CEO compensation to investors, the public, and other stakeholders. Due to the great disparity in CEO and employee retirement savings, criticism of inside debt is likely to increase. These debates generally are fueled by the amount of compensation, which leads to criticism of certain types of compensation due to the associated values, ignoring the incentive effects of inside debt. As the disparity between CEO compensation and employee compensation continues to grow, companies face greater challenges in explaining compensation packages. However, inside debt compensation is a tool that can address frustrations regarding excessive risk taking, myopic quarter-to-quarter focus, and long-term sustainability goals. Companies need to be careful to structure inside debt so that it is most effective and to explain the incentive impact. This could help educate the public and investors as to why this form of compensation can be useful.

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