



## Stanford eCorner

### Tying Pay to Performance

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Video URL: <http://ecorner.stanford.edu/videos/2191/Tying-Pay-to-Performance>

During the 2008/2009 era of the government bailout of the banks, Stanford President John Hennessy strongly suggests that executive compensation should be directly tied to measurable performance in any enterprise. He points to current research that found that the best performing companies on Wall Street - even during this stifling climate - have CEO's whose earning are tied to measurable profitability.



#### Transcript

Obviously, a bailout is the last resort. Something in a capitalist society, you should do only because the danger to unrelated businesses which are not responsible exceeds the moral hazard of bailing somebody out. And that's exactly the dilemma in which we find ourselves now. I actually don't believe in capping executive compensation, but I do believe in something that we've forgotten about in many walks of the corporate sector and the banking sector which is that compensation should directly tie to performance. Directly tie to performance. You lose \$40 billion of people's money, you shouldn't get \$500,000, you should get zero. Zero! That's where your compensation starts. You should get stock in the company so that when it plummets in value you feel the same pain that the people who lost all that money. That's what should happen. And our big problem is that we've gotten away from tying executive compensation to measurable performance of CEOs.

And in fact there's some wonderful research done by one of our faculty members in the law school that shows that the best investments in the stock markets are in companies which pay their CEOs well but tie the CEO pay to CEO performance. It makes perfect sense. If they're paying their CEO well but they've tied it to his performance, he's earning a lot of money, the shareholders are happy campers because the company is doing well. That's what we need to get back to and that's the kind of mindset we need. We don't have all the proper tools. I mean, options are tool that have pluses and minuses in doing this. Other tools have difficulties. But paying people large bonus packages, guaranteeing them that even if you decide to fire them, this isn't the way to generate the right kind of behavior among the leadership of a company. So we need to go back and fix this now and it'll get fixed. And hopefully lots of people will decide that they'd rather be in one of these great entrepreneurial sectors than in the banking sector in the future.