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HEADS I WIN, TAILS YOU LOOSE-THE NEED TO REFORM EXECUTIVE COMPENSATION

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Abstract: Executive compensation and incentives systems have been shown to be dysfunctional, misaligned and short-sighted. Greed and narrow self-interest have thrived, and risk and stewardship have been too often ignored. Added to this, the enormous disparities in remuneration levels between top executive pay levels and average wages is raising serious questions about equity and fairness that poses material risks to corporations. Reform of executive compensation is essential and if blunt and problematic regulation is to be avoided it needs to be led by boards. In the reform process, boards need to embrace responsible stewardship, enlightened governance, and sound risk management in reining in the excesses and realigning the incentives. In particular, incentives need to be restructured to better align executive behaviors with long-term value creation and to remove pressures and temptations on executives to pursue narrow self-interests.

Keywords: Executive compensation, stewardship, corporate governance, rewarding virtue, respecting risk

The Case for Reform

Executive incentives and remuneration systems have been firmly put back under the spotlight by the fallout from the Global Financial Crisis (GFC). Dysfunctional, misaligned and short-sighted incentives drove greed and narrow self-interest which crowded out sensible risk management and responsible stewardship, thereby triggering the crisis - just as they did in the string of corporate scandals over recent decades.

When such rivers of narrow self-interest and executive greed go unchecked - just as they did with the GFC - they ultimately form into seas of long-term economic and corporate value destruction. But equally, such rivers of narrow self-interest and greed can be checked, cleaned-up and redirected into seas of value and virtue when the excesses and systemic misalignment of executive incentives are rigorously addressed and reformed.

Despite the elevated debate on the urgent need for radical reform of executive compensation, regulators continue to struggle with reform proposals. In fact, few of the regulatory reform efforts go to the heart of the problem – the conflicts of interests between executives and the outcome that executive compensation has become largely decoupled from long-term shareholder wealth creation. Added to this executive incentives increasingly have been built around ever larger short-term rewards that have tended to incentivize increased risk taking. At the same time, executives too often have been shielded from any material downside or appropriate liability for such risk taking decisions.

Despite the problems, executive compensation is generally viewed as a potential instrument for addressing the conflict of interest and moral hazard issues that can arise between shareholders and managers - the so called agency problem. But at the current time, executive compensation structures themselves act in the opposite way and are a big part of the agency problem itself. In large part, this situation has developed because of the important influence that managerial power and executive rent extraction have had an on the design of executive compensation arrangements. Clearly, corporate boards need to urgently take back full control of executive compensation and embark on serious reforms to address these central problems.

For a start, boards need to ensure that all executive compensation and incentive schemes are designed against the reality that:

A. The CEO and his or hers executives are first and foremost employees. They are hired to serve the interests of the firm and are typically not owners entitled to legal rights of personal dominion over the assets of the firm.

B. CEOs and executives, as employees, act under the principles of agency law which requires them to: 1) demonstrate good governance; and 2) meet their duties of loyalty and due care in the execution of corporate office.

C. The principal test of executive success is long-term company performance and profitability, as reflected in fundamental market valuations.

Not only should executive compensation and incentive schemes reflect these facts, they should also be clearly set out in employment contracts as part of the rights, obligations, ground rules and duties within which executives must operate. The most basic of these duties are to: be honest; keep promises; treat stakeholders fairly, respect their rights, and take due care of their interests; and be accountable. Too often, these fundamental duties are ignored in the design of executive compensation and incentive schemes.

The Need to Rein in the Excesses

Executive compensation levels have increased at a remarkable pace over the past 30 years. In 1980, the CEOs of the top US companies, on average, received pay package worth 40 times the earnings of the average American worker. Leading into the GFC in 2007, the average annual pay package of CEOs of the S&P 500 companies had skyrocketed to 344 times the average American worker, or US$10.5 million (Institute for Policy Studies and United for a Fair Economy, 2007). That is, for just one day's work, the top US CEOs got paid the equivalent of what the average US worker got paid for the full 2007 year.

In other developed counties the pay packets of CEOs have also skyrocketed. In Australia for example, CEO pay has dramatically increased over the last 30 years, with the CEOs of the top 20 companies in the 2008-09 year receiving on average 110 times the average wage of Australian workers, or approximately AUD$7.2 million (Productivity Commission, 2010).

Despite blazing headlines declaring falls in CEO pay on the back of the GFC (Lublin, 2010), the situation has changed very little. In fact, the total compensation of the CEOs of the largest US firms only declined by a modest 3% in 2008 (Wall Street Journal /Hay Group, 2009) but this was then offset by a similar 3% gain in 2009 (Wall Street Journal /Hay Group, 2010).

Perhaps of more concern are reports that many board compensation committees have sought to protect their CEOs from the full flow on impacts of the GFC by moving away from longer term

performance-based compensation programs, lowering the bar on annual performance targets and paying out higher bonuses for less profitable results (Wall Street Journal /Hay Group, 2010).

The situation has been little different in Europe. While top executives' base salaries were stagnant on the back of the GFC in 2009/2010, bonus payouts jumped and drove higher total pay (Hay, 2010). Not surprisingly, the enormous disparity in remuneration levels between top executive compensation and average wages has already triggered vocal questions on equity and fairness. In fact, Peter Drucker, arguably the greatest management thinker of the last century, thought that a ratio around 25-to-1 was more appropriate - much beyond that, Drucker asserted, makes it difficult to foster the kind of teamwork that most businesses require to succeed over the long term (Wartzman, 2008).

Drucker described the pocketing of huge sums by CEOs, while they are laying off workers or presiding over corporate failures, as "morally unforgivable." Drucker's view was that the CEO's job is "to do what is right for the enterprise—not for shareholders alone, and certainly not for themselves alone", and that they have a special duty to show that they were "just a hired hand" (Wartzman, 2008).

Drucker's outrage is proving to be right in at least one critical respect – the extremely generous and growing CEO pay packages are proving to have very little to do with superior creation of shareholder wealth (Bebchuk & Fried, 2004). Larger compensation certainly has not prevented poor performance of firms and in some it looks like it has been a contributing factor to corporate problems (Daines, Nair, Vinay & Kornhauser, 2005).

Drucker is also likely to be ultimately right in his concern that the current extreme level of income inequality is not sustainable. Such income inequality is only readily tolerated when the rising tide is lifting all the ships. Given this is not happening, boards would be wise to act before equity and fairness issues begin to materially tear and erode internal company harmony as well as corporations' implicit community license to operate.

The Alignment Challenge

The CEO and the executive team lie at the fulcrum of corporate decision-making and the structure of executive incentives holds to the key to aligning executive behaviors with their responsibilities. These responsibilities extend first and foremost to the creation of long-term sustainable shareholder value through: successfully implementing the firm's strategic goals and objectives; inspiring and managing the hierarchy of employees; and providing vision, direction and responsible stewardship.

The executive compensation vehicles boards have used to attempt to align executive behaviors with the creation of long-term sustainable shareholder value have predominately been a base salary, sizeable short-term cash incentives, and so called long-term equity linked incentives (usually in the form of share options).

Typically, the sizeable short-term cash incentive component has been based around achieving sales, revenue or bottom-line targets. The problem with this is that such short-term targets can often only be achieved or bettered through increased risk taking. In fact, it was risk linked short-term incentive structures that sowed the seeds of the US sub-prime crisis which triggered the GFC. When the achievement of short-term incentives targets is made possible via increased risk taking, the risk is that executives are provided with a greater incentive to do the wrong thing than to do the right thing in terms of longer-term shareholder value. This is particularly the case when performance or sales are not

tracking to plan (often due to external factors) or something else has gone wrong.

In designing such executive compensation schemes, boards appear to have placed considerable weight on the power of executive self-interest under the belief that you only get what you pay for. They are right in one respect. It is certainly a reality of human nature that when presented with the opportunity to secure attractive and large personal gains, nothing much gets in the way of self-interest. And when the short-term cash bonus carrots are so attractive, the longer-term interests of shareholders and other stakeholders are typically crowded out and don't an appropriate look in.

Added to this, the share options based longer-term compensation structures have been poorly aligned with shareholder interests. The problem is that the returns to executives from executive options typically bear little resemblance to the returns to shareholders from holding ordinary shares. As the Australian Productivity Commission noted, "options provide more (possibly excessive) 'upside' incentive than shares, but little downside risk. Once 'under water', they provide little incentive to drive an incremental increase in share price" (Productivity Commission, 2009). These problems are largely removed if grants of fully paid but escrowed shares are used as longer-term incentives for executives, rather than grants of share options. Clearly reform is needed as the current structure of executive compensation falls well short of appropriately aligning the conduct and interests of executives with the longer-term interests of shareholders.

Restructuring Executive Compensation

Key Role of the Board

Enlightened action by boards to rein in excessive and misaligned executive compensation is essential as regulatory imposed requirements, such as caps on CEO salaries, are typically problematic and likely to have unintended consequences. But inaction by boards to reign in and restructure executive compensation is unfortunately forcing regulatory responses such as the Australian Government's current proposed executive remuneration reforms which include a requirement that boards be spilled if the company's remuneration report receives "no" votes of 25% or more at two successive AGMs (The Parliament of the Commonwealth of Australia, 2011).

Boards need to act and good corporate governance and stewardship should be the starting point. The board is at the apex of a company's internal incentive structure and it is the board's decisions that shape the incentives culture for the whole organization and determine whether or not virtue – or its opposite – will be rewarded.

Two fundamental good governance principles stand out and should be adopted by all boards:

- First, the board chair and the chair of the remuneration committee need to be truly independent. All boards should separate the roles of the CEO from that of the board chair and boards should not appoint former CEOs as the chair; and
- Second, executive compensation plans should be, at a minimum, put to a shareholder 'advisory' vote.

Beyond such governance fundamentals, 'how executives are paid' is more important than 'how much they are paid' in terms of the impacts on long-term value creation and on the alignment of executive behaviors. Boards should therefore start by fixing the obvious alignment problems with executive incentives structures.

For a start, boards need to recognize that beyond financial rewards, people are also motivated by power, status, approval and recognition, and the intrinsic value of their activities. If the board's incentive focus is too narrow or too short-term, and it ignores the legitimacy of the means by which success is achieved, it risks rewarding behaviors and outcomes that destroy long-term value. Boards therefore must give enough weight to the intangible aspects of executive compensation and behavior, and not simply evaluate and structure executive compensation in purely financial terms. In particular, boards need to make the penalties for irresponsible and value-destroying behaviors readily apparent and they need to incorporate the intangible drivers of responsible behavior into a 'balanced scorecard' gate opener for executive rewards to be triggered.

Avoiding the Perils of Short-term Incentives

As discussed above, the greatest weakness in many executive compensation structures is the linking of short-term incentives to the meeting of sales or pure revenue targets. Pressures to drive sales at all costs or to complete the big sale to trigger the lucrative cash bonuses loom large under these structures. This weakness is certainly not a theoretical one - incentivizing mortgage sales, without due regard for the suitability and the risk of those sales, drove the US sub-prime crisis. And examples of remuneration driven miss-selling can be readily found across other industry sectors.

These conflict of interest perils of revenue and sales linked incentives are compounded when the board allows the same executive to be ultimately responsible for both the design of the incentives and for: a) the setting of the income or sales objectives themselves; or b) product design with approval authority over the complexity of products, including the transparency of pricing and charging structures etc.; or c) product advertising including choices about how forthright or otherwise the copy should be.

Poorly aligned short-term incentives also pose conflict of interest challenges in dealing with possible health and safety, environmental, bribery and corruption, and purchasing risks. A more balanced reward structure - taking account of intangible value drivers such as the quality of sales, customer satisfaction levels, health and safety and so on – would assist in overcoming the conflict of interest challenges and make it easier for executives to behave appropriately.

Boards should therefore put much less weight on short-term incentives and much more on longer-term ones, so as to avoid driving behaviors that destroy long-term value. The over emphasis on achieving short-term financial goals simple heightens the risks that executives will ignore the reality that sustainable value for a company's shareholders only accrues over time. As already mentioned the over-emphasis on short term incentives simply heightens the likelihood that executives may not elevate material risks or emerging performance problems to the board in a timely way, particularly if it may impact the determination of sizeable short term cash rewards.

Key Reform Measures

Beyond the two good governance principles, relating the board independence and shareholder advisory votes on executive compensation plans, already mentioned, there are a number of other measures that boards should implement as part of broader reforms to executive compensation. Where short-term performance based rewards are utilized, a material part (50% or more) of the earned rewards should be deferred so as to better align the incentives with value creation beyond the immediate-term and to allow rewards to be clawed back should undisclosed problems emerge later.

A number of other important reforms have been spelt out by the Caux Round Table (CRT) that would promote improved disclosure and risk management relating to executive compensation plans and which would better align the plans with long-term shareholder wealth creation (Caux Round Table, 2009). As part of a broader reform agenda, the CRT recommended that:

- "Corporate boards should be required to make annual disclosures (and at the time of the appointment of any CEO) detailing conflicts of interest and other risks embedded in executive performance incentives, including how the Board proposes to manage such risks; and the degree to which the remuneration structure aligns executive interests with those of shareholders.
- All equity linked remuneration should be in the form of common equity, escrowed for a minimum period of five years regardless of continued employment.
- Board members and key executives should be prohibited from borrowing or hedging against the common equity they hold in the company, unless there is full and timely disclosure of all such borrowing or hedging.
- All termination payments should be capped at one year's remuneration, unless there is prior shareholder approval of a higher amount."

These recommendations sit alongside the CRT Principles for Responsible Business (Caux Round Table, 2010) which go to the heart of constructive and ethical business behaviors through which corporations can flourish and sustainable prosperity can become the foundation for a fairer, freer and more transparent global society.

Conclusion

The design of executive compensation systems is highly relevant if the interests of business executives are to be balanced with those of shareholders and other stakeholders and with the aspirations of society for mutual and sustainable prosperity. The can be no better example than the GFC of what can go wrong when the balance is wrong - opacity of risk, combined with incentive-fed greed and narrow self-interest in a rising market, proved a toxic mix for serious mischief.

Boards need to act given that current executive compensation and incentive structures are in large part dysfunctional, misaligned and short-sighted. Failure to act will inevitability result in blunt and problematic regulatory action. In reforming executive compensation, Boards need to embrace enlightened governance and sound risk management. In doing so, they need to restructure incentive structures so that they to better align executive behaviors with long-term value creation and remove the pressures and temptations on executives to pursue narrow self-interests in securing the large cash bonuses on offer.

Business of course must be profitable in order to meet its social obligation of wealth creation. But the sustainability of those profits depends greatly on how such profits are made and how the interests of relevant stakeholders are catered for – which is why executive compensation and incentive structures matter so much.

Notes

1. Similarly, just 60 percent of managers felt that CSR required them to consider the expectations of the general public when designing business strategies

2. GoldenBee Development Center for Chinese CSR finds that Chinese firms' submitted 582 CSR reports in 2009, up from 169 in 2008 and just 64 in 2007 (http://www.csr-china.net/en/second.aspx?nodeid=d5dad5b2-2453-4015-9bb2-d650db593831&page=contentpage&contentid=6514d4a1-1f4b-4df7-9047-ed408333254c) .

3. The 2009 Fortune China managerial survey finds only 26.1 percent of participating firms published an annual sustainability/CSR report in 2009.

4. See Williams, O.F. (2004) and Kell, G. (2005).

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