How Boards Can Rein in CEO Pay

Graham Kenny

The wolves are out and circling on the question of CEO pay, since more and more executives are walking away with their pockets lined while their organizations flounder. Take, for example, Tom Albanese, who stepped down as CEO of Rio Tinto, one of the world's largest mining companies. He departed with millions in cash and shares early last year — and yet the company has struggled to resuscitate itself.

That could explain why its annual report allocates a mind-blowing 41 pages (out of 244) to executive compensation. It's an exercise in justification, and the logic is off-base. Showing how pay aligns with a narrow set of key performance indicators (KPIs) has become a higher priority than making sure the metrics are relevant to the organization's health. And that's a common phenomenon in corporate reporting. Many companies — like Rio Tinto — devote almost as much space to explaining their hellishly complex remuneration schemes for senior executives as they do to accounting for performance.

How did we get here? Because of a big problem with governance.

Following advice from remuneration consultants, boards have unwittingly increased the pressure on themselves to come up with outsized rewards for chief executives. They're told that CEOs have to be "incentivized" (beyond a base salary) to do the job they're hired for. It's quite bizarre. This incentive system includes bonuses for other members of the senior team, at a significant cost to the company. We're all aware of the outcome — the discrepancy between senior executives' compensation and the average for their organizations has never been greater. So boards scramble all the more to justify their positions on pay, which feeds the industry that has developed around designing executive packages. It's a classic vicious cycle.

As a result of all this, corporate performance measures today overemphasize financial results and focus almost exclusively on the perceived needs of shareholders to the neglect of other stakeholders.

It's time for boards to make two important changes to bring CEO compensation in line with measuring company health:

Measure more things. It's tempting to simplify — to seek just a handful of metrics that show exactly how well the organization and its CEO are performing. But you'll run into problems if you narrow them down too much. Rio Tinto supplies seven KPIs in its annual report, five of which are purely financial (such as "underlying earnings") and two of which are ad hoc ("all injury frequency rate" and "greenhouse gas emissions intensity").

To strike a better balance, a board needs a *system* of measures that together reflect the needs of all key stakeholders — not just investors.

Measure for the short *and* long term. When companies look at a few metrics over a long period of time, they tend to think they're measuring long-term performance, but that's not really the case. Consider QBE Insurance, one of the top 20 global insurers. In its annual report, QBE provides a five-year performance "snapshot" of eight metrics*:*

- Net profit after income tax
- Return on average shareholders' funds (ROE)
- Earnings per share
- Combined operating ratio
- Insurance profit
- Underwriting result
- Dividend per share
- Dividend payout

But the CEO's long-term incentive comes as shares vested in just three years, and it's subject to two performance hurdles: half the award depends on ROE, the other half on relative total shareholder return (RTSR). Note that RTSR is *not* one of the organization's key performance metrics.

Measurement that's truly long term gauges the current health of the organization and anticipates future performance — and the board must hold the CEO accountable for both. This requires a different lens.

Your board should be looking at causal connections between what's going on today and what's expected sometime hence: for instance, how employee results are driving customer results, and how those are propelling shareholder results. Mapping those relationships and including the related targets in your CEO's scorecard is the way to keep both the chief executive and the organization on track. If your CEO engages and motivates employees today, he or she will be more likely to satisfy your customers down the line and, after that, satisfy your shareholders.

The current push to justify CEO compensation stems from short-sighted governance. If boards don't start thinking more broadly about how to track performance — measuring a range of outcomes, both for today and the future — they'll continue to face harsh criticism for being weak and for short-changing their organizations. And executive pay will keep skyrocketing.

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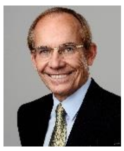

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