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Female quotas on boards: Should we have them?

It's lonely at the top: Depression and CEOs

What to do about overpaid CEOs

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Paid to fail

WHAT BOARDS CAN DO ABOUT OVERPAID CEOS

The public is outraged by CEOs who get big payouts even as their companies are failing. Iain McCormick looks at how Australia handled this issue – and what boards can do here.

"SHAMEFUL" IS HOW President Barack Obama described the recent behaviour of Wall Street bankers as they awarded themselves nearly US$20 billion in bonuses at a time when the economy was going downhill and the US government was using billions to bail out huge financial institutions, according to the *New York Times*.

Obama said that senior executive pay packages fostered the excessive risk-taking that had led in part to the financial crisis. His administration declared a salary cap of US$500,000 for employees with companies that gained the largest bail-outs.

Not only are some senior executives grossly overpaid, but there is a range of cases where they have been paid for failure.

The *NY Times* also reported on CEO Robert Nardelli's pay for poor performance at the US firm Home Depot, as a classic example of excessive executive pay. He received about US$45 million a year over the six-year period when he was CEO, as the share price plummeted from more than US$50 a share to US$41.16 just before his resignation was announced.

When he was removed from the role, Nardelli was given a US$210-million golden handshake. Rivals of Home Depot paid their CEOs about a third less than Nardelli during the same time, and investors gained significant increases in their share prices.

Henry McKinnell left Pfizer with an exit package of US$213 million, including an US$83 million pension, after the company lost more than US$137 billion in market value in the six years he was CEO. Morgan Stanley rewarded its CEO Philip Purcell with an exit package of more than US$113 million when he was forced out in 2005. Both Tom Freston of Viacom and Carly Fiorina from Hewlett-Packard were awarded tens of millions of dollars when they were fired. It does sound like pay-for-failure!

Fred Whittlesey, chief compensation officer at PayScale, which provides access to compensation data, reports chief executive pay in the US may be between 250 and 500 times that of the average worker.

The situation is rather different in New Zealand where statistics show the average chief executive officer of the 44 largest companies now earns $1.29 million – 29 times the median income of full-time salary and wage earners of $44,200.

> **"The average Kiwi chief executive officer of the 44 largest companies now earns $1.29 million."**

The recent Australian Productivity Commission Inquiry Report on Executive Remuneration echoed Obama's view that there is a perception that the structure of pay in the financial sector was a major contributor to the global financial crisis.

The inquiry report suggests that there was strong growth in Australian executive pay from the 1990s to 2007. A number of examples of large payments, despite poor company performance, have led to concerns that senior executive salaries are out of control.

Despite the concerns, the inquiry found that the pay for CEOs of the top 100 companies has grown by 13 percent a year, from the mid-90s to 2000, and then increased by around six percent annually in real terms to 2007. Since 2007, average salaries have fallen by around 16 percent a year, returning the average to 2004-05 levels. It appears that the rise and decline in executive pay over the 2000s largely reflects increased use of pay structures that are linked to company performance.

But the inquiry concluded that CEO pay levels do sometimes appear inconsistent with the labour market and the levels of company performance. It suggests that incentive pay systems modelled on US processes and introduced without appropriate controls produced large pay rises, but more recent and sophisticated incentive pay systems had slowed the growth. The inquiry also reported that some senior executive termination payments do look excessive, perhaps caused by overly compliant boards.

The answer to the issue, the inquiry suggested, was to strengthen the corporate governance framework.

WHAT THE BOARD CAN DO

There are a wide range of actions any board can take to ensure that CEO pay is appropriate and fair. The inquiry has five major suggestions.

IMPROVING BOARD CAPACITIES

As boards provide the bridge and balancing mechanism between management and owners, they must be filled with competent and independent decision makers. They need the right mix of skills, knowledge and experience to balance the pay levels of senior executives with the interests of shareholders. The ability to balance diverse interests can be threatened by the thin 'gene pool' of company directors when recruitment is done within the ranks of the 'directors club' and the small group of known senior executives. When recruitment works like this, there is likely to be a very strong board identification with the interests of the senior executive.

Improving the diversity of boards could also assist in more balanced debate and decisions. The Inquiry reports that women constitute just over eight percent of directors of ASX200 companies. The situation is similar here where 60 of the top 100 companies on the New Zealand stock exchange have no women on their boards and only three of the top 100 companies added a woman to their boards in the past two years. Women hold only 8.65 percent of board directorships of the top 100 companies on the NZX with 54 female directorships held by 45 women out of a total of 624 directorships. Female representation on boards is 5.73 percent in the listed New Zealand Debt Market companies, and 5.07 percent female board representation in the 28 companies listed on the New Zealand Alternative Market (NZAX).

Board diversity should consider not only gender, but skill, experience, background and mindset mixes. It's wise to do board capability audits before recruiting to ensure diversity.

It would also be useful to adopt and disclose a diversity policy statement by all larger companies that includes measurable objectives relating to gender, experience and skill mix.

AVOIDING CONFLICTS OF INTEREST

Conflicts of interests can easily arise in the area of pay. The use of board remuneration committees consisting of non-executive directors allows a single focus on setting executive remuneration and addresses conflicts of interest that happen when executive directors can directly influence their own pay. CEOs and executive directors should not participate on remuneration committees.

The inquiry recommends that remuneration committees should have at least three members, consisting of non-executive directors, a majority of whom are independent, be chaired by an independent director and have a charter that sets out procedures on non-committee members attending meetings.

IMPROVING REMUNERATION DISCLOSURE

The inquiry suggests that remuneration reports in annual reports have become of lesser value because of their complexity and lack of detail. They suggest boards produce a plain English summary of pay policies, set out the actual pay levels and total company shareholdings of individuals named in the report.

Conflicts of interest can arise when remuneration consultants are employed who have strong links to the senior management or the board. The inquiry says companies should disclose the names of remuneration advisers, who appointed them, and the nature of other work undertaken by the advisers for the company.

DEVELOPING EFFECTIVE REMUNERATION POLICIES

Linking pay to performance is useful to align the interests of executives and shareholders. However, these systems need to be carefully designed and highly complex systems can easily lead to perverse outcomes. It is useful to have clear, simple remuneration systems that have a mix of short- and long-term incentives, and with a deferral of payments to enable performance to be validated over time.

Boards need to develop clear links between strategy implementation and pay levels so the balance with shareholders interests can be achieved.

FACILITATING SHAREHOLDER ENGAGEMENT

Voting at annual, special or extraordinary general meetings is the main method that shareholders have to hold boards accountable. Voting can be by shareholders attending these meetings or by proxy. The inquiry recommends the use of electronic voting for proxies, as it would remove most of the downsides of the paper-based system, such as lost votes, illegible proxy forms and processing error. An electronic system would also enable a full audit trail, which would give further confidence about the results of contentious or close voting results.

Shareholders are able to vote against company remunerations reports and the inquiry suggests that where a company's remuneration report receives a 'no' vote of 25 percent or more at an annual meeting, the board should explain in its subsequent report how shareholder concerns were addressed and, if they have not been, the reasons why. In addition, where the subsequent remuneration report receives a 'no' vote of 25 percent or more of eligible votes cast at the next annual meeting, a resolution should be put that the elected directors who signed the report stand for re-election at an extraordinary general meeting.

In conclusion, the public perception of CEO and senior executive pay is a critical matter for companies to consider. The financial crisis has brought to light a number of unacceptable practices that have reflected badly on the competency of corporate governance. While there is little evidence of overpayment of CEOs in New Zealand, it is important for boards to actively grapple with the balance between senior executive and shareholder interests.

Boards can do a lot to improve the perceived fairness of CEO remuneration including ensuring they have a diverse range of independent thinkers as members, actively managing potential conflicts of interest, improving remuneration disclosure, developing effective remuneration policies that reward long-term company performance and ensuring effective shareholder engagement over remuneration matters.

Iain McCormick PhD runs www.DirectorEvaluation.com an Auckland-based governance evaluation consultancy that offers free paper-based evaluations, a comprehensive range of web-based evaluations and full consulting-based services.