INSEAD

The Business School for the World®

INSEAD Governance Meeting
In collaboration with the
Association of British Insurers (ABI)

CEO Remuneration: The Way Ahead London, June 14th 2010

In a year when remuneration committees are facing unprecedented shareholder, governmental and public pressures over CEO compensation, the first INSEAD Governance Meeting (IGM), held on 14 June 2010 in London, assembled a select group of chairmen, directors and investors from Europe to discuss how to improve CEO remuneration in the current corporate governance context. Hosted by the Association of British Insurers (ABI), it welcomed more than 35 delegates for an in-depth discussion of what has become a controversial topic. Key contributors to the debate are summarised in this document

Participants included such diverse business leaders as Countess Diego du Monceau, vice-chair of the board of UCB, Sir Christopher Hogg, former chairman of Reuters and a non-executive director of the Bank of Scotland, Penny Hughes, member of the boards of Royal Bank of Scotland, Cable & Wireless, Morisson and Home Retail, Peter Montagnon, senior adviser to the UK Financial Reporting Council, Christine Morin Postel, member of the boards of 3i, British American Tobacco, and Royal Dutch Shell, Lord Simon of Highbury, board member of GDF-Suez and former vice-chairman of Unilever, Karen de Segundo, member of the boards of British American Tobacco, Ahold and Poyry Oyj, and investors such as Paul Lee from the Hermes Fund and Anita Skipper, Director of Aviva.

Good CEOs are not necessarily better paid

Under the direction of Professor Ludo Van der Heyden, Director of the INSEAD Governance Initiative, the discussion started with the key issue of how to assess the long-term performance of the CEO. Should it be assessed over a period of 3 or as many as 10 years? Is even 10 years sufficient?

"The real test of a CEO's leadership has to be how the company does over his or her full tenure", explained Urs Peyer, INSEAD Associate Professor of Finance and co-author (with Herminia Ibarra and Morten Hansen) of a research paper on the relation between cumulative CEO pay and cumulative value creation over the CEO's tenure. Presenting a global ranking of CEOs of large public companies that performed best over the duration of their tenure, Urs Peyer explained that only by analyzing performance over a CEO's tenure and even beyond, taking into account succession, can we start to understand the nature of corporate leadership.

One immediate implication of the research is that no country or industry has taken the lead in generating excellent performance, which can be found across all industries and all geographies. A second is that the longer perspective brings to the forefront "quiet" CEOs who deliver outstanding results while managing to keep away from front-cover media stories – one such quiet leader is Samsung CEO Yin Jong-Yong. Probably most important is the conclusion that CEO performance over her/his lifetime does not appear to correlate with compensation.

A fundamental insight was that CEO packages, particularly in the US, are pretty much determined by Hay-like benchmarks. These benchmarks have one major drawback: they tend to "average out to the mean", whereby highly performing CEOs end up being relatively underpaid for their performance, whereas underperforming CEOs are insufficiently sanctioned pay-wise. In response to this objection, Professor David Young presented his concept of CEO "wealth leverage", which measures the degree to which CEO compensation is driven by increases in corporate wealth.

The benefit of shares or options with long vesting periods

Professor Young's presentation on the best ways for tying executive pay to long-term shareholder value opened provocatively with a summary of the research he has done with Steven O'Byrne, a US-based compensation consultant. According to David Young: *"Most boards think their compensation packages do well because of high pay at risk, and extensive use of stock options and competitive pay. But the reality is very different."* He argued that the focus should be on the strength of financial incentives using the "wealth leverage" metric. Because US-based data are easily available from electronic databases, his research focuses on US companies. The computation of executive wealth leverage (EWL) is not hard to do, he explained. Computations refer to correlation numbers such as 4. Interestingly there can be greater leverage for most executives on sales growth than on shareholder value.

A high-performing pay programme is also one which first puts a relatively high percentage of total compensation in stock or options with long vesting periods, and second, instead of providing option grants that are fixed in monetary terms, attaches the option grant in term of shares: *"Boards should make more use of shares or options with long vesting periods."* One idea worthy of serious consideration is requiring CEOs to block vested options and shares for a specified period after vesting – the CEO should be allowed to cash them in only further down the road, which would tie the remuneration to long-term shareholder value.

The belief that the best way to run efficient companies is to give top executives incentives to maximise shareholder value by linking pay to share prices was seen by some participants as very US-oriented. Many agreed that the applicability of options and other long-term types of incentives was more relevant in a US context and thus recognised big divergences between pay arrangements, especially in continental Europe. One participant presented a simpler view that salary-based packages may not be optimal, but served to pay the monthly bill.

It starts with what you strive for

The idea is to establish principles that provide proper incentives and proper principles for aligning CEO remuneration more closely with corporate wealth creation and performance. Comments included: "*When it comes to hiring and remunerating a CEO you cannot predict his or her performance over the next ten years."* Equally important should be *"considering at which point in the economic cycle you appoint your CEO, before you reward him/her",* noted another senior board member. When it comes to a company's current performance, history and cycles matter. While the size and complexity of the organisation are important indicators, all agreed there is more than one solution. In practice, this area remains problematic. *"Who should be empowered to oversee the CEO job, and who is entitled to tell the board what creates value in their company?"* asked a board member, implying that boards of directors are more responsible than many people give them credit for. "*Why would regulators or private equity do a better job than the board in this field?"*

Yet keeping the sense of a fair deal is essential

This prompted an ongoing debate: Are chief executives overpaid? Amongst the participants there was a widespread consensus on the excesses of top executive remuneration. The distortions that have been produced by the short-term focus of CEOs' pay arrangements have been "*absolutely ridiculous*". And there was general agreement that the problem has afflicted companies in general – though its consequences may have been especially severe in the case of financial firms. Some argued that large executive pay packages were the result of powerful managers setting their own pay. Others interpreted the same evidence as the result of optimal contracting in a competitive market for managerial talent via mechanisms of the sort exposed by David Young.

From there the discussion moved on to new rules on executive pay disclosure, particularly in Japan, which may have thrown up some anomalies already and also driven up pay. Pay disclosure did not meet with unanimity but was deemed to be a battle already decided. European firms now benchmark pay against international peer groups in their own industries. "*With global benchmarking, now you see no difference from the US, and a salary offered in one big city sets a floor in another,"* stressed an independent board member of several listed companies. Another pressure driving up pay, according to a participant, is the growing "industry" of remuneration consultants who charge fees depending on the size of the package agreed.

There was a consensus amongst the participants that a sense of a fair deal should be anchored not just to avoid mistakes or promote performance but to achieve outstanding levels of lasting greatness. For this reason, companies should make sure that financial incentives are not exaggerated.

One participant advanced the view that CEO incentives should be based on broader indicators such as "*a job-driven indicator"* whereby CEOs *"might instead aim to create jobs"*. It would induce executives to take into account the effects of their decisions on all stakeholders. Therefore, the key board debate should not be about how much and how to pay to the CEO, but rather about how to make sure that the best CEO is in place. Second, it is important to understand the basics of motivation: the stronger source of motivation is internal rather than external.

Engage all stakeholders

For the second part of the programme, participants were divided into small group to discuss various items: the remuneration committee's role, independent and non-executive role, board interaction with shareholders and best policy practices.

One key issue that stood out was the ever more critical role of the chairman, who is a person on which requirements seem to pile up with regularity. This is where having good skills on boards is becoming a must, including expertise on CEO compensation practices.

Another key issue in this context was defining and judging the performance of the non-executive director (NED) within the remuneration committee, particularly in terms of technical skills. According to one participant, it is important that the NED has the courage to raise a hand, ask the right questions and invest the time and energy required to understand the business. A lot of attention is focussed on processes rather than looking at strategic goals, this NED deplored.

Group participants on board interaction with shareholders (mainly investors), fully agreed with the "US-centric view" of long-term shareholder value creation and hoped for greater alignment in Europe between the board, NED and shareholders, noting that communication between the "vocal" shareholders and the board was vital to avoid a shareholder revolt. Asked about best practices, the latter group admitted the difficulty of establishing best practices, which stems primarily from differences in culture, size of company, environment, and particular needs in view of specific strategic agendas.

Sylvie Bergeron
June 23rd 2010

INSEAD Governance Initiative

Tel. +33 (0) 1 60 98 33 19
www.insead.edu/governance

With a commitment to providing ongoing education to the business community, INSEAD (www.insead.edu) is dedicated to shaping the next generation of internationally-minded board members. The ***INSEAD Governance Meetings (IGMs)*** *are one of the three pillars of the INSEAD Governance Initiative, alongside the INSEAD International Directors Programme, the INSEAD Governance R&D programme, and the development of pedagogical materials. Founded in 2010, the INSEAD Governance Initiative is located in Fontainebleau, France.*

Europe Campus
Boulevard de Constance
77305 Fontainebleau Cedex, France