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Fixing What's Wrong with Executive Compensation

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Furor over bankers' pay has once again put the spotlight on executive compensation. Stories from the financial sector about senior executives who received large annual bonuses in 2008 even as their company's stock price suffered massive declines have provoked widespread public criticism. What appears to be a persistent disconnect between executive pay and a company's results in the capital markets has inspired renewed demands that companies "pay for performance"—this time, in a way that really works.

The issue is not limited to the financial sector. The Boston Consulting Group recently studied changes in CEO compensation between 2007 and 2008 at 158 U.S. companies with more than \$5 billion in revenues. Nearly all the companies (94 percent) had negative total shareholder return (TSR) in 2008, and, as one would expect, the average level of CEO pay declined from the previous year.¹ And yet, about 40 percent of the companies with negative TSR actually paid their CEOs *more* in 2008 than they did in 2007.

In Europe, the disconnect may be less pronounced, but it is still present. For example, the 30 companies that make up the German DAX (which includes most of the largest corporations in that country) saw CEO compensation decrease by about 21 percent on average in 2008. Yet those same companies experienced an average decline in market values that was nearly twice as steep, at 40 percent.

The fact that the recent stock-market declines have made executive stock options worthless at many companies could end up exacerbating the criticisms about executive pay. This reality presents compensation committees with an unwelcome dilemma. Either they do nothing (and risk demotivating top managers and even losing key people) or they exchange now-worthless options for new ones at current market prices (and risk fueling shareholder and even regulatory opposition to what increasingly looks like a "heads I win, tails you lose" system).

Given these circumstances, we think that now is a good time for companies to step back and take a systematic look at the purpose and the design of their executive-compensation programs. Any such review should be guided by the following five principles for creating effective incentive compensation:

- ◇ *Emphasize the long term.* Investors want managers to focus on creating sustainable long-term value, not just beating this year's plan—especially in today's recessionary environment.² Therefore, incentive compensation plans should have a bias toward the long term, relying on longer vesting periods and multiyear performance targets.
- ◇ *Reward relative performance.* Equity-based incentive compensation, such as stock options or restricted stock grants, should reward executives when the company outperforms its peers, not just when it enjoys a windfall in the stock market. Performance metrics for such compensation should therefore be based on relative, not absolute, performance by indexing a company's performance to that of a designated peer group.
- ◇ *Measure performance that executives can directly influence.* Overall company performance may be an appropriate metric for senior executives at corporate headquarters. But lower down in the ranks, executives are less able to control corporatwide outcomes. In general, executives at the business unit

1. TSR is the most comprehensive and widely accepted measure of shareholder value creation. TSR measures the change in a company's stock price, plus its dividend yield, over a given period of time.

2. For an analysis of recent investor perspectives, see *Valuation Advantage: How Investors Want Companies to Respond to the Downturn*, BCG White Paper, April 2009.

level should be evaluated according to financial and operational performance metrics that are relevant to the units they head.

- ◇ *Focus on value creation, not just earnings or the P&L statement.* It is critical that the internal performance metrics a company uses take into account how executives use the capital entrusted to them, not just whether they are able to meet plan targets to improve earnings per share (EPS) or the P&L. That means holding executives accountable for the size and sustainability of the cash flows they generate after reinvestment and for the capital bets that they make.
- ◇ *Minimize asymmetries of risk.* For executives to truly act like owners, they need to experience the same risks that normal investors do. In addition to allowing executives to enjoy the benefits of a potential upside, an effective incentive-compensation system must also ensure that they suffer the costs of a potential downside by putting some portion of their own wealth at risk.

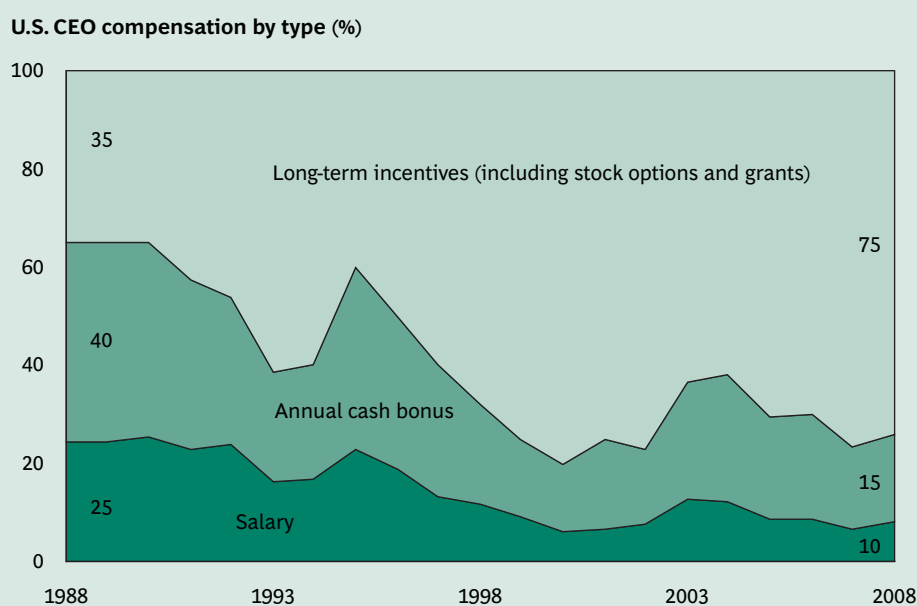
In this paper, we explore a few of the ways that companies can put these principles into practice. But in order to understand why these specific principles are so important, we must first address a fundamental irony: the very compensation systems that many criticize today are the product of nearly two decades of efforts to achieve precisely the goal of closely linking pay to performance. So why haven't they worked?

Understanding the Flaws of the Current System

The vast majority of executive compensation systems today consist of three basic components: a fixed base salary, an annual cash bonus, and long-term incentive compensation, usually in the form of equity vehicles such as stock options or grants of restricted stock. Although the precise percentages vary by country, company, and management level, the overwhelming trend in recent years has been to make variable pay—and long-term variable pay in particular—an ever-larger part of the total executive-compensation package.

Consider Exhibit 1 by way of illustration. It shows that variable pay, as a percentage of overall compensation for U.S. CEOs, has grown dramatically in the past two decades—so much so that it represented a full

Exhibit 1. In the Past 20 Years, Long-Term Incentives Have Emerged as the Dominant Form of Compensation for U.S. CEOs



Sources: "Historic CEO Compensation," *Forbes*, April 30, 2008; "The Wall Street Journal Survey of CEO Compensation," *Wall Street Journal*, April 2, 2009; BCG analysis.

90 percent of CEO pay packages in 2008. Furthermore, long-term incentive compensation grew especially fast to become the largest component of CEO pay packages, representing 75 percent of overall pay.

Of course, this dramatic growth in the share of long-term incentive compensation is in part an artifact of the run-up in market values during this period. But it also reflects a conscious choice on the part of companies to shift the mix of the executive pay package toward longer-term equity vehicles such as stock options and restricted stock grants. The problem, however, is that these dominant forms of long-term incentive compensation are rarely linked to meaningful long-term performance metrics. As a result, they do not function as effective incentives. Consider the following common shortcomings:

- ◇ The amount of stock options or grants an executive receives is typically based on industry benchmarks, not company performance. According to a recent *Forbes* magazine compensation survey, 86 percent of the companies in the S&P 500 set the amount of pay on the basis of what other companies pay their executives.³
- ◇ The ultimate value of an executive's stock options or grants reflects the absolute performance of a company's stock, not its relative performance against the stock of its competitors or peers. As a result, arbitrary factors—for example, whether options or grants happen to vest at the height of a bull market or the trough of a downturn—carry more weight than whether the company is actually creating more value than its competitors.
- ◇ Relatively few executives (usually only those at the very top) can significantly influence a company's overall stock price or TSR. Because options and grants by definition reward total company performance, they turn out to be quite a weak incentive to create value at the level of the individual business unit.

The paradoxical effect of these shortcomings has been to weaken, not strengthen, the connection between an individual executive's performance and long-term value creation. Executives may benefit from gains or suffer from declines in the company stock price, but for most executives, long-term incentive compensation, as currently designed, has aspects of a casino—"nice to have," perhaps, but not determinative of their behavior. As a result, individuals tend to see the annual cash bonus as the more meaningful and, therefore, more motivating component of variable pay.

But the limitations of most annual bonus plans have by now also become painfully clear. The narrow focus on single-year performance against the company's strategic plan encourages executives to game the system by negotiating easy-to-meet targets, adopt a narrow focus on maximizing short-term results, and incur risks that boost near-term returns even if those returns prove unsustainable over the long term. It also allows them to benefit from volatility in company performance: they are rewarded handsomely during the up years but are not punished equivalently during the down years, since there is no such thing as a negative bonus.

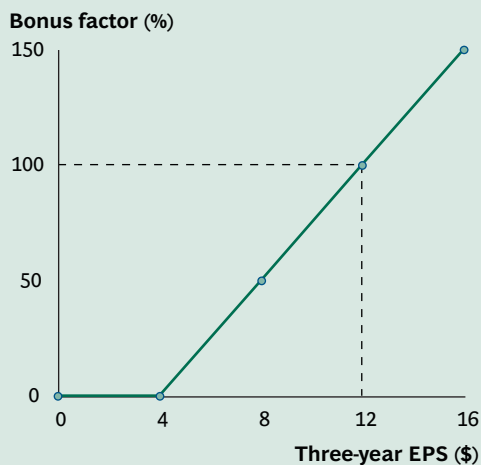
Even worse, the internal financial and operational metrics typically used to determine the annual bonus often do not really measure what creates value in the business. Too often, managers are rewarded for beating plan targets for, say, increasing sales, growing EPS, or improving their P&L. But such metrics either reward growth irrespective of its impact on profitability or reward profitability without consideration of how much capital was invested to achieve that goal. They also encourage companies to retain earnings even if, from a value creation perspective, there might be better uses for that cash—for example, returning it to investors in the form of dividends.

Exhibit 2, drawn from our work with one of our clients, illustrates a common result. In an attempt to encourage a long-term focus, annual bonus awards at this company were based on three-year performance. But the sole metric used to judge executive performance was EPS. Analysis showed, however, that EPS growth was not a strong driver of value creation in the company's business. Put simply, the company's bonus plan did not really reward value creation. For instance, from 2004 through 2008, the company's overall bonus payout grew consistently—even in 2006 and 2008, when the company's share price actually declined.

3. See Emily Lambert, "The Right Way to Pay," May 11, 2009, at www.forbes.com.

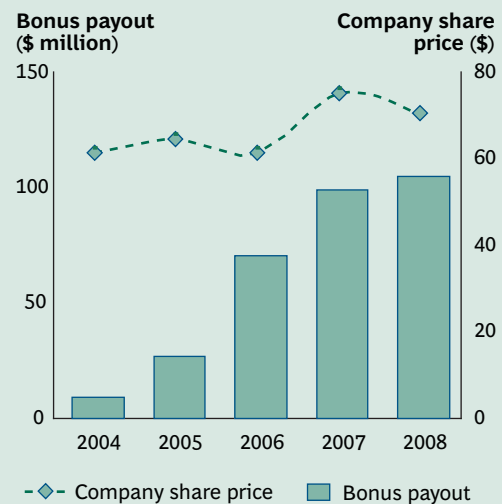
Exhibit 2. The Performance Metrics Typically Used to Set Variable Pay Are Often Poorly Linked to Actual Value Creation

At one company, three-year earnings per share (EPS) determined executive bonuses ...



Source: BCG analysis.

... resulting in ever-rising bonus payouts despite the uneven performance of the company's stock



Finally, there is one further problem with all forms of variable pay—whether short term or long term, based on cash or on equity. There is always a financial upside for executives (and sometimes that upside is quite high), but there is not an equivalent downside. To be sure, executives may not receive a bonus if they do not beat their targets in the company's plan, or they may find that their options are worthless if the company's stock tanks. But in neither case is their own wealth genuinely at risk, as it is for the typical investor. This asymmetry of risk between executives and investors reinforces a short-term focus and encourages imprudent risk-taking.

Our five principles for the redesign of executive compensation directly address these shortcomings of today's equity-based long-term compensation and cash-based bonus plans. Now we turn to some ways that companies can put these principles into practice.

Putting the "Incentive" in Long-Term Incentive Compensation

The design of an appropriate executive-compensation system is highly dependent on a company's context, and the precise details will vary from company to company. Still, the basic goal of any redesign of equity-based vehicles for long-term incentive compensation should be the same: to create a more direct impact on executives' motivation and behavior. The way to do so is to make equity compensation subject to rigorous performance criteria. There are two simple ways for companies to achieve this goal.

Require executives to buy company stock. The most straightforward way to make long-term compensation a genuine incentive is to require executives to purchase company stock as a condition of participation in the long-term incentive plan. Some companies, for instance, require executives to buy common stock equaling anywhere from two to four times their salary, depending on their management level. Some even provide loans to those who cannot afford the purchase on their own. Unlike options or grants, mandated stock purchases require executives to put their own personal wealth at stake. This adds an element of risk to long-term compensation and thus aligns the interests of executives more closely with those of shareholders. (See the sidebar "Learning from Private Equity.")

Make equity compensation conditional on outperforming peers. Even if a company continues to use traditional options and grants, it can design them so that they are rigorously based on performance. The

Learning from Private Equity

When it comes to using equity stakes to get executives to act more like owners, public companies can learn from the extensive experience of the private-equity (PE) sector. One especially important lesson is to think of equity stakes in the company not so much as compensation *for* executives but as necessary investments *by* them in the future performance of the business.

PE firms require a broad range of managers at portfolio companies to purchase significant equity stakes in the company. This requirement not only applies to the senior team but also can cover anywhere from the top 20 to the top 80 managers, depending on company size.

Equity stakes create a powerful alignment between the people running the company and the PE firm's investors. They function as an attractive "carrot" because they allow executives to take advantage of the massive leverage that often accompanies PE deals. And by forcing executives to expose themselves to significant downside risk, they also function as a potentially painful "stick."

Requiring executives to purchase equity stakes has another advantage for the PE firm as well. When a firm is considering taking a company private, the condition that the company's executives must invest can be a mechanism for forcing important information about the business into the open. If, for example, a key business-unit head at a potential acquisition is hesitant about making the necessary investment, this fact sends a strong signal that the PE firm needs to dig deeper in its due diligence. What does the executive know about the real prospects of the company or the business unit that the PE firm does not? Does he or she have critical inside information?

Executive compensation at PE portfolio companies also often includes an equivalent to stock options—a right to buy stock in the company in the future when it is taken public in an initial public offering. CEOs at portfolio companies, for example, typically receive two to three times their initial equity in such options. But vesting periods tend to be relatively long compared with those at public corporations—often as much as five years.

most effective mechanism is to make both the size of the award and the terms of vesting conditional on a company's relative TSR performance compared with an appropriate peer group. Under this approach, an executive can exercise stock options or take full possession of stock grants only when the company's TSR outperforms its peer-group average. Indexing a company's value-creation performance to that of peers eliminates the possibility that executives will benefit simply because the market as a whole is generating unusually high returns.

One U.S. retailer, for example, has designed its performance-share plan to create a balanced focus on both absolute and relative market performance. Shares are vested after a three-year performance cycle—but only when the company's TSR is positive *and* outperforms the average TSR of companies in a designated peer group determined jointly by the company's president and the board's compensation committee. Because the company's goal is to be in the top quartile of its peer group, however, executives receive the full amount of their initial award only if the company's TSR attains the seventy-fifth percentile of its peer group. Should the company do well enough to reach the eighty-fifth percentile of its peer group, they receive 125 percent of the initial award.

Whatever approach or combination of approaches a company decides is most appropriate to its own situation, it must make the criteria of its equity-based compensation plan as transparent as possible—not only to employees but also to shareholders. Companies are already experiencing considerable pressure from shareholders and regulators over compensation.⁴ It is critical that they respond actively to investors' growing desire for a "say on pay." Shareholders should not have to scour the company's proxy statement to understand how executives are being paid. Performance criteria for both options and restricted stock grants should be spelled out clearly. And to avoid any suggestion of possible insider trading, vesting dates

4. In a statement at the London meeting of the G20 countries in April, for example, the G20's Financial Stability Forum said that "in the future, all the stakeholders of financial firms, including supervisors, shareholders, and (where firms are systematically important) governments, will expect to receive more information about compensation policies and to increase their engagement with them." See *FSF Principles for Sound Compensation*, a statement of the Financial Stability Forum, April 2, 2009.

should be defined carefully to follow, not precede, major public events such as annual meetings or analysts' calls.

But even the best-designed equity-based compensation program will have its limits. As discussed earlier, because such programs are based on overall company performance, they become less relevant lower in the management ranks. Although it certainly makes sense to base some portion of a second- or third-level executive's compensation on overall company performance, that portion is likely to be considerably smaller than that of the CEO—and the cash bonus, based on internal financial and operational metrics relevant to the executive's unit, will be relatively larger. So how can companies move beyond the traditional concept of the annual bonus in order to make variable cash payouts an effective incentive for value creation over the long term?

Moving Beyond the Annual Bonus

Despite its evident shortcomings, the annual bonus has two distinct advantages. First, it rewards performance on the basis of the internal financial and operational targets over which executives have direct control. Second, because of its tight link to what executives manage, its regular frequency, and the immediacy of payout, it can be highly motivating. The challenge is to retain this motivational impact while minimizing the short-term thinking and behavior that yearly bonuses so often encourage. There are three things that companies can do to strike this balance.

Establish internal metrics that actually drive value creation. The goal of internal performance metrics should be to make sure that managers are prudent stewards of the capital allocated to them. So instead of relying on simple accounting metrics such as growth in EPS or in the P&L, companies should emphasize relevant value-based metrics such as return on capital and free cash flow.

It is also important to customize each business unit's specific targets so that they are aligned with the unit's designated role in the company's overall portfolio strategy. A leading specialty-chemicals company, for example, assigns each of its more than 45 lines of business to one of three roles in the company's overall portfolio: *growth businesses*, with strong prospects for long-term expansion and sustainable profitability based on clear competitive advantages; *financing businesses*, with solid competitive positions and the aspiration to be important sources of net cash flow; and *turnaround businesses*, which require major restructuring or possible exit in order to create value. In addition to defining the aspirations and key performance indicators for each business, these roles also determine the specific metrics used to evaluate executive performance.

Some companies go even further by using metrics that explicitly estimate TSR at the business unit level. In effect, this approach treats a company's business units as independent companies competing for capital in a kind of internal stock market. Units are responsible for delivering a required level of cash-flow return on investment through some combination of sales growth, margin improvement, and increased asset productivity. The internal TSR system uses metrics equivalent to a company's capital gain—that is, it incorporates the increase in the intrinsic value of the unit, typically measured by growth in sales and margins. It also tracks a unit's "dividend" contribution by measuring the cash flow that the unit returns to corporate after reinvestment. Internal TSR metrics are a comprehensive way to ensure that a company's internal targets are tightly linked to what actually creates value for shareholders.

Reward multiyear performance. Once a company has identified the appropriate performance metrics, it can then turn its attention to extending the time frame by which bonus amounts are calculated. Instead of basing bonuses exclusively on annual results, a company should tie part or all of them to a moving average of multiyear results. This approach has the advantage of preserving the motivational power of annual payouts while also linking them more closely to longer-term results and limiting rewards for cyclical rebounds or windfalls. And by encouraging executives to think in terms of performance over multiple years, it also restrains the impulse to take dangerous risks in order to maximize single-year results.

Make the payout conditional on sustainable performance. Companies can go a step further by distinguishing between the period for which a bonus is awarded and the period during which it is actually paid

out. One approach to extending the payout period that has recently received a lot of attention from regulators and other critics of current compensation systems is the so-called bonus bank. In this system, some portion of the payout for a particular year's bonus award is deferred over subsequent years and made conditional on future performance.

A major European bank, for instance, recently instituted a variable cash-incentive plan in which a given year's award is paid out over a three-year period. However, executives can also receive a negative bonus in a given year—a so-called malus award—if they miss their performance targets, take excessive risks, or otherwise damage the institution's financial position. The amount of this negative award is deducted from the deferred cash that has accumulated in the individual's bonus bank. (See Exhibit 3 for an illustration of how such a system works.)

The bonus bank approach allows a company to preserve significant aspirational bonus awards while at the same time ensuring that the actual payout of those awards is at risk and dependent on the future performance of the unit in question. Because executives may actually lose some or all of their deferred bonus compensation, they have a strong incentive to focus on delivering results that are sustainable and to actively manage risk. Such systems must be designed carefully, however, to minimize the complexity and maximize the transparency of their operation for both executives and investors.

By linking cash payouts to internal metrics that drive value creation at the business unit level and by extending the time frame for the award and payout of cash-based compensation, companies can address two problems at once. They can ameliorate a key shortcoming of vehicles for equity-based long-term compensation by linking such compensation more effectively to metrics that managers can influence. And they can alleviate the short-term focus of the annual bonus, while still preserving the motivational impact of annual cash payouts.

Meeting the Challenge of Executive Compensation

Creating an effective performance-based executive-compensation system is always a complex balancing act—part art, part science. All the mechanisms discussed in this paper have their advantages and disadvantages. For the sake of simplicity, we have distinguished clearly between external, market-based performance metrics and internal, financial and operational metrics, and between equity-based incentives and cash incentives. But it is possible to design a variety of hybrid forms. For example, companies can use both external and internal metrics to determine the award of performance shares (in order to tie them

Exhibit 3. A Bonus Bank Puts a Portion of a Bonus Award at Risk, Making It Dependent on Future Performance

	Year 1	Year 2	Year 3	Year 4	Year 5
Bonus bank balance ¹	0	6	10	2	6
+ Bonus award	9	9	0	7	6
- "Malus" award	0	0	7	0	0
Interim balance	9	15	3	9	12
x Payout ratio	33%	33%	33%	33%	33%
Annual payout	3	5	1	3	4

Source: BCG analysis.

Note: This example is for illustrative purposes only.

¹All amounts shown are in millions of U.S. dollars.

more closely to individual business-unit performance); use internal metrics alone but pay out incentive awards in both cash and restricted stock (to encourage company stock ownership among executives); and use external metrics alone but pay out incentive compensation in the form of cash, not actual shares (in order to avoid the dilution of company shares).

The precise combination of mechanisms appropriate for any individual company will depend on the complexity of its business, the specifics of its strategy, the key drivers of value creation in its industry, and the priorities of its investor base. Getting the balance right is a complex challenge that requires careful coordination and alignment across multiple high-level units: the board's compensation committee, the senior team, corporate finance, investor relations, and HR. It also requires the good judgment to sense when the "best" is becoming the enemy of the "good"—for instance, when the technical comprehensiveness of a proposed design comes at the price of too much complexity, making the system difficult to understand by both employees and investors. (See the sidebar "Ten Questions About Executive Compensation That Every Company Should Know How to Answer.")

Given the many shortcomings of current compensation practices, however, companies cannot really avoid the challenge. The economy is moving into a new period that will have a major impact on company strategy and investor expectations.⁵ Now more than ever, it is critical that a company's approach to executive compensation be designed carefully to support the company's business strategy, its TSR goals, and its investors' expectations and priorities. The rules of the game are changing. Executive compensation has to change along with them.

5. For BCG's perspective on the strategic and operational implications of the current downturn for companies, see the BCG Collateral Damage series.

Ten Questions About Executive Compensation That Every Company Should Know How to Answer

1. *What are the implications of our business strategy and our approach to value creation for our executive-compensation system? What behaviors are we trying to motivate? Does the system support our strategy? Does it encourage our executives to act like owners?*
2. *Is the overall pay package appropriately balanced? Between fixed pay and variable pay? Between short-term-variable and long-term-variable pay? For each level of the management ranks?*
3. *Do we have the right mix of payout vehicles? Are the terms of payout appropriate for the kind of behavior we are trying to motivate?*
4. *Is variable pay truly conditional on performance? Do our criteria for awarding stock options or other equity vehicles include more than just industry benchmarks, an executive's level, or years of service?*
5. *Do we have the right time frames? Do they match the risk window of our strategy and our investments?*
6. *Are we measuring performance relative to peers? Are we confident that we have the appropriate peer set? Do we understand the operational and financial factors that drive relative valuation multiples in our peer group?*
7. *Are individual executives rewarded for performance that they can actually influence? Are performance metrics customized to the role of individual business units in our strategy? Is our compensation system insulated from the effects of industry cycles or broad stock-market trends, over which executives have no control?*
8. *Do our performance metrics reward value creation rather than just earnings? Do they take into account how effectively executives are using the capital provided them?*
9. *Is there a genuine tradeoff between risk and reward? To what degree is executives' compensation at risk? Does the system have both an upside and a downside?*
10. *Is the system transparent? Is it simple enough for employees to understand? Do our investors understand our approach to compensation? And is that approach aligned with their expectations and priorities?*

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