Principles of Executive Compensation

Chapter 1: Introduction

The Purpose and Importance of Executive Compensation

The best approach to executive compensation is a principles-based approach. That's the core premise of Willis Towers Watson's *Guiding Principles of Executive Compensation*. The aim of this introductory chapter is to support that premise by highlighting the purpose and importance of executive compensation in the context of a broader argument: high-performing corporations are increasingly important to global society—beyond economic growth—and a strategic, principles-based approach to executive compensation helps to drive optimal business performance. That means creating an effective executive compensation system ultimately generates value for senior managers, their companies (including other employees), the economy, and society.

It's important to understand the *human* factor in compensation. Companies are organizations of people, and people have natural energy, creativity, and ambition—what might be called an innate "life force" or natural motivation—that can be tapped into through various means.[1] Incentive systems are only one way to harness, focus, and enhance that motivation, typically in service of the purpose, mission, and strategy of the organization. Other means of harnessing motivation within a corporation include commonality of purpose, strong culture, and the like. But compensation is a core element in motivation and can contribute significantly to individual and collective success or failure.

Note that incentives, including those provided by executive compensation systems, are not inherently good or bad. An incentive system can harness people's motivation productively, such that they exert maximum effort toward proactive problem-solving and collaboration that generates business, social, and environmental impact, along with ongoing engagement and satisfaction. But in other cases an incentive system can focus people on activities and outcomes that ultimately destroy value on multiple levels. In still other situations an incentive system can be overly controlling and restrictive, dampening creativity, teamwork, and motivation, leading not to desired outcomes but to a growing sense of deadness throughout the organization.

In this context, let's consider how incentive systems play a role in business situations reflecting a variety of outcomes.

Examples of Incentive Systems in Action

The examples below highlight the heterogeneity of outcomes related to incentive systems in a range of corporations across sectors.

Incentives can drive explosive growth and innovation. Apple under Steve Jobs made good on the iconic leader's commitment to making a "dent in the universe." The corporation achieved its explosive growth—fueled by a steady stream of innovative, game-changing products including the iPod, iPhone, and iPad—in part by using generous stock options to motivate executives and other employees to

[1] Nietzsche discusses this life force as a sense of "aliveness" present in all humans but requiring engagement to be fully realized. See for example Friedrich Nietzsche, *The Selected Writings of Friedrich Nietzsche*, Start Publishing, 2012.

create value. The incentive system rewarded not specific financial results but value created by filling unmet or even as-yet-unknown consumer needs. Apple's people were expected to make big sacrifices, and they did so more willingly because of the incentive system in place.

Peer tech giant Google also drives outsized growth and innovation, but with a different approach. The firm has advocated the idea of "paying unfairly," or designing the incentive system to reward top performers disproportionately—to boost their ongoing engagement and accountability. Mounting research shows that a firm's highest performers—including gifted C-level executives—generate an overwhelming percentage of results, so they should be compensated accordingly.[1] This seems to be working in Google's case.

Incentives can promote consistent, steady results. Notwithstanding the examples above, it's not all about explosive, innovation-fueled growth. Many companies enjoy consistent growth and profits quarter after quarter, year after year, in part by harnessing their people's motivation through well-designed incentive systems. Consumer goods stalwart Kimberly Clark, for example, has a strategic, integrated compensation system that connects performance measures for people at every level of the organization. For instance, the metrics for managers overseeing the smallest international business units roll up to be components of the CEO's performance measures; similarly, the CEO's performance criterion of earnings per share rolls down to be reflected in business-unit-level metrics. In this way, the compensation system components are mutually reinforcing, with coordination of everyone's goals and performance measures, and clarity about how each of these contribute to the firm's overall performance. The CEO, for example, can see the objectives and metrics for anyone else in the organization, and how these relate to his. The system has helped drive Kimberly Clark's steady performance improvements over decades.

Automotive OEM Borg Warner provides a similar example. A consistently strong performer in its sector over the last two decades, the Detroit-based company relies on a longstanding incentive structure with a simple but highly disciplined set of financial measures and goals. These require management to consistently grow cash flow in excess of the cost of capital. The system has resulted in a disciplined focus on core elements of value creation that has driven consistent performance in one of the country's most challenging industries during turbulent economic times.

Incentives can promote behavior that destroys value. Incentives were part of the problem for the financial services firms that collapsed and/or destroyed enormous value during the Great Recession. Within that sector, compensation systems contributed to a broad pattern of unchecked and sometimes reckless behavior, including trades and complex transactions that were highly profitable in the short term but created disastrous long-term consequences. For many financial services firms, suboptimal but powerful incentive systems motivated excessive risk-taking—through ever-more creative financial instruments and other products—that overexposed companies to potential downfall and ruin, ultimately destroying significant economic value for the companies and broader society. Companies like Bear Stearns and Lehmann Brothers, for example, effectively "over-harnessed" their people's motivation, promoting engagement and behavior focused largely on personal gain and short-term returns, without sufficient accountability or guardrails. Unlike the examples above, compensation

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[1] For a discussion of the disproportionate impact of high-performers, see Josh Bersin, "The Myth of the Bell Curve: Look for the Hyper-Performers," *Forbes*, February 19, 2014, http://www.forbes.com/sites/joshbersin/2014/02/19/the-myth-of-the-bell-curve-look-for-the-hyper-performers/ (accessed May 4, 2015).

systems in these situations promoted a lack of discipline, leading toward chaos rather than positive results.

Incentives can deaden energy and motivation, leading to poor performance. In a more subtle negative scenario than the example above, incentives can promote diminished expectations and contributions, ultimately driving low performance. Kodak provides a good example. In the 1990s, as digital cameras rose in popularity, the company rewarded its people primarily to continue business as usual: generating revenue and profits based on its established lines of film and film-related products. This system, which would have resulted in little motivation to develop new products, likely contributed to the presence of Kodak's CEO on a *Harvard Business Review* list of top executives with the "worst incentives" (or the most negative relationships between CEO compensation and value created).[1] There is even evidence that a Kodak engineer filed a patent for a digital camera well before that product hit the mass market, but there was likely little incentive to capitalize on this innovation.[2] Compensation systems that uphold the status quo in companies that need to innovate to survive will typically deaden energy, motivation, innovation, and performance.

Kodak may illustrate the more general, endemic example of deadening incentive systems that result when companies set unchallenging goals and/or accommodate excuses for poor performance. More specifically, some firms set performance targets based on minimal annual growth, such as improvement in line only with more general economic growth. The boards of these businesses don't push sufficiently on goal-setting, and executives have little incentive to push their performance. In other cases, established performance ranges may be too wide, resulting in significant incentive payouts for mediocre performance. Finally, in these or other scenarios management may offer multiple excuses for why they failed to meet financial performance goals—such as the sale of a business unit or the presence of unusual expenses—but still deserve the promised incentives. All of these situations result in poor engagement and/or accountability, with compensation for mediocre performance or even outright failure.

Why It Matters

As the examples above suggest, the consequences of incentive systems include both smaller- and larger-scale impact for a range of stakeholders. Most fundamentally, we know that effective executive compensation programs support the achievement of an organization's mission, vision, and strategy, as well as its short- and long-term objectives. This should help create value for shareholders, employees, and customers alike. We also know that effective programs reinforce choices about the type of talent an organization wants to attract and retain, as well as key values and behaviors that are expected of this talent. Thus, effective executive compensation can help bring cohesion and congruence to both the ultimate objectives and ongoing processes of an organization.

But the impact of compensation systems stretches well beyond the performance of a specific company, sector, or even country to our global economic health. High-performing companies create growth and prosperity on every level, by generating opportunities related to employment, healthcare, education, and better standards of living. A growing cadre of business leaders, including Harvard Business School dean Nitin Nohria, have called for corporations to generate impact well beyond that

[1] Michael Jensen and Kevin Murphy, "CEO Incentives: It's Now How Much You Pay But How," *Harvard Business Review*, May-June 1990, https://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how (accessed May 4, 2015).
[2] Lloyd Shefsky, *Invent Reinvent Thrive*, McGraw-Hill, 2014.

associated typically with business value.[1] In fact, for-profit firms are much larger, more complex, and more global than they were even 20 years ago, with significant influence on the allocation of resources and quality of life in most communities.[2] The world increasingly expects large corporations to deliver multiple kinds of value.

Firms drive global value in part by designing and deploying strategic incentive systems that motivate and engage their people with the company's purpose, mission, and strategy, in a truly aligned and accountable way. Such organizations effectively harness the capabilities and creativity of their management teams and other employees, driving performance and creating broad value. In contrast, when companies use suboptimal incentives, they can deaden motivation, creativity, and performance, or even promote behavior that destroys large-scale global value.

Our research supports that enduring high-performing companies pay in a specific, effective way that their lower-performing peers do not. We will discuss this in more detail in later papers. In short, incentive systems matter, and there are strong benefits to designing strategic, thoughtful systems that really work—along with negative consequences for having a suboptimal compensation system in place.

The Need for a Principles-Based Approach

Executive compensation is a thorny, complex topic rife with emotional elements and difficult tradeoffs, as the examples above suggest. With the advent of "say on pay" votes in a growing list of countries and intensifying shareholder, government, and public scrutiny of executive pay in major corporations worldwide, executive compensation has become a lightning rod for criticism and a symbol of how organizations govern themselves and respond to the concerns of various stakeholders. As such, it's easy to make any compensation-related discussion about what is right or wrong, fair or unfair, moral or immoral. In reality, the most useful discussion and thinking in this domain is aimed at *what works and what doesn't* to drive the right kind of results for the organization, its people, and broader society.

Understanding what will work best in a given incentive system is challenging. The use of a set of valid, mutually reinforcing principles can help us navigate this difficult terrain with optimal results. This body of work will outline a core set of overarching (higher-level) and operating (on-the-ground) principles that can help companies design incentive systems to harness the innate energy, creativity, and motivation of their people for maximal performance—performance that benefits everyone.

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[1] See for example Diana Middleton, "Harvard Business School Names New Dean," *Wall Street Journal*, May 4, 2010, http://www.wsj.com/articles/SB10001424052748703866704575224433181083858 (accessed May 5, 2015).
[2] See for example Jason Saul, *Social Innovation, Inc.*, Jossey-Bass, 2010, and Anant Sundaram and Adam Inkpen, "The Corporate Objective Revisited," *Organization Science*, 2004, 15(3), 350-363.

About Willis Towers Watson

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