

The Value of a CEO

Executive pay has been in the news again, with recent reports of the remuneration packages of Sir Ralph Norris, CEO of Commonwealth Bank of Australia, and George Frazis, head of Westpac New Zealand. Some claim they are unfair or undeserved.

How should we think about the high pay of some CEOs? Here's my take. Comments welcome.

Start with other professions where leading players get high rewards, such as football and entertainment.

Top footballers like Wayne Rooney and Cristiano Ronaldo are paid far more than most CEOs (without great controversy).

Leading actors like Tom Cruise and Julia Roberts earn millions for just one film. Should we regard it as unfair if we don't look as good or act as well as them and get paid less? The reality is that such actors are worth a great deal to movie studios at the box office and are able to claim large rewards.

What is at work here is the usual economic interplay of supply and demand. Major drawcards in the football and film industries are scarce – hence the name 'stars'. The very best CEOs are also very scarce – managing a large firm is difficult.

What is a CEO worth? Occasionally we get a market indication. When the Hewlett Packard board recently dumped its highly successful CEO Mark Hurd for understandable reasons, HP's market capitalisation immediately fell by 8% or \$9 billion.

Obviously HP would appoint another CEO. The value decline was the market's assessment of HP with Hurd as CEO versus someone else.

As always there are confounding factors in this case, but at first blush the company could have been better off paying about \$2 billion for the next 5 or 6 years to keep Hurd than to lose him.

I was 7 years on the board of a very large SOE (ECNZ) and 5 on the board of a company that ended up in the top 20 on the ASX. I saw at first hand the enormous value that Roderick Deane and Peter Smedley added to those companies.

In thinking about pay, it's best to put yourself in the position of a member of a company board. CEOs do not set pay; directors do. Clearly it is their duty in the interests of shareholders to get the very best person they can find and afford to run the company.

In seeking that person, they are operating in a highly competitive, often international, managerial labour market.

Obviously they can't afford to pay too much, otherwise their company would suffer in the market place. At the same time, high CEO pay is minuscule in the context of a large business.

Ralph Norris's \$16 million package is conditional on meeting a number of performance hurdles.

But even taking the headline number, it is just 0.00084% (84 one hundred thousandths of 1%) of CBA's revenue or 0.0017% (17 ten thousands of 1%) of its after-tax profit.

Senior executive remuneration in the bank has been approved by an average shareholder vote of around 90% in recent years, and 96% this year.

It's not hard to understand why. Under Ralph's leadership (a time which includes the GFC), nearly \$30 billion has been added to shareholder value over and above dividend payments; total shareholder returns have been the best in the industry; the bank has gone from fifth to second place on the ASX; and it has achieved the greatest improvement in customer satisfaction of any Australian bank.

Of course, boards can over-pay and make poor hires. Investors can rightly feel aggrieved about poor performance, especially if so-called 'golden handshakes' are involved, although often these follow from earlier contracts and exit is in the best interests of shareholders.

Misguided employment and anti-takeover laws also serve to protect under-performing CEOs.

In New Zealand, executive pay is not at stratospheric levels relative to some other countries, and governments sensibly have not interfered with it.

However, the Bolger government made a mistake in following overseas trends and mandating disclosure.

As with so many regulations, this has arguably had the opposite effect to that intended – to curb pay. Executive pay was once a closely guarded secret; now executives know what peers are paid, which is to their advantage in salary negotiations.

The best, but unlikely, reform would be to scrap the mandatory disclosure law. Require full disclosure to shareholders of director remuneration – the implicit contract is between shareholders and boards – and avoid the pay ratchet associated with remuneration surveys. Shareholders themselves should decide whether further disclosure is in their interests.

Markets are not perfect, but they are often better than the alternative – government intervention. In the managerial labour market, like others, you generally get what you pay for. In the interests of shareholders, customers and employees alike, New Zealand needs the best CEOs its companies can afford and attract.

Roger Kerr is the executive director of the New Zealand Business Roundtable. Check out his blog on www.nzbr.org.nz