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Commonwealth Bank CEO Ian Narev received a healthy remuneration package in 2016 despite scandals involving the bank. Paul Miller/AAP

We need to change more than pay for executives to do better

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The pay of executives of a company, whether in salary, bonuses or other types of remuneration, is usually justified as an incentive to improve the financial performance of a company. This has led to ever more complex performance packages with increasing percentage of variable, performance-based payments.

But what is increasingly evident is that this definition of a role of an executive needs to change, as do the incentives, to act not only in the best financial interests of the company but to focus on how it serves the wider community.

How executive pay changed for the worst

Executives payments are in the spotlight in Australia and overseas, yet again as companies report this information.

As the market for top executives is global, there is a limited talent pool. In essence, if an Australian company is not prepared to pay the going rate, the talent will go elsewhere in the world to where a company is prepared to pay.

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The design of executive pay in Australia has undergone significant change since the mid 1990s, when executive pay began to pick up. A smaller percentage of an Australian executive's reward package was subject to performance incentives 20 years ago. A majority were on fixed pay or with short-term bonuses payable when they reached a specific measurable target. Today, the variable component of executive pay is much higher.

Findings from a survey on executive remuneration by the Australian Human Resource Institute shows that within Australia, executive pay is typically comprised of three components: fixed remuneration and short and long-term incentives.

This three-part structure is endorsed by the human resource profession as it acknowledges not only the skill and experience an executive brings to a role (fixed remuneration) but the effort an individual executive makes to change performance and culture leading to better financial performance (short-term incentive) and improvement to shareholder returns (long-term incentives).

However, an increasing number of studies show these type of performance schemes do not lead to better organisational performance and actually have dangerous outcomes. This is because it incentivises executives' risk-taking and short-term orientation and can lead to disastrous outcomes, such as the Bear Stearns and Lehman Brothers collapses.

A 2003 Australian study shows that performance-based executive remuneration has not lead to increased performance by Australian companies. Current executive remuneration focuses heavily on short-term financial performance ignoring other success factors, such as customer satisfaction.

BHP CEO Andrew Mackenzie felt the temporary effects of the current system of executive remuneration. David Crosling/AAP

For example, Commonwealth Bank CEO Ian Narev is one of the highest paid executives in Australia in 2016 despite a series of recent scandals that shook the bank.

Another distortion created by finance based incentives is the temporary effects of executive payment packages. BHP CEO Andrew Mackenzie's pay was halved due to the company's loss and he was left to deal with decisions made by his predecessor. The former CEO, Marius Kloppers, walked away with a sizeable pay package in large part due to his term coinciding with very favourable economic conditions for mining and the fact that he could vest both his short and long-term incentives before leaving.

These limitations of current performance-based payment schemes have led to the proposal of payment packages that enable executives to sell only a fraction of shares awarded to them each year. This includes a specified number of years after retirement, combined with limitations on unwinding.

Such schemes still reward executives for improving companies' performance but do not lead to short-term thinking and risk-taking. Unfortunately, changes to performance payment schemes are still rare.

The alternatives

While some companies in the US have started to bind performance payments to long-term results, such as Goldman Sachs, Procter & Gamble and Morgan Stanley, companies in Australia still haven't followed suit. One Australian organisation that has made changes to address the above challenges in executives' remuneration is fund management agency the Future Fund.

There are more radical suggestions such as completely abolishing pay-for-performance. The suggestion to abolish performance payment is aligned with the concept of stewardship.

Stewardship is about placing others' long-term interests ahead of personal goals that serve an individual's self interests. According to stewardship theory, executives are custodians of their organisations and are intrinsically motivated to contribute to their welfare and prosperity. It's their personal beliefs and intrinsic motivation that drives their performance, not performance-based payments.

Revising performance structures is just one measure to increase stewardship among executives. Stewardship is based on fundamentally different assumptions about human nature than financial performance incentives. It emphasises the social orientation and profession-like behaviour of managers.

However you can't rely on human nature alone, other measures are needed to change the institutional context in which businesses operate.

These include changing the laws to reflect that the role of business in society goes beyond financial performance. Another measure is changing business education to cultivate future business leaders in moral judgement and accountabilities.

The recruiting process can also change to select candidates with demonstrated long-term orientation and care for all stakeholders, rather than based on the current focus on past financial performance. Another measure is introducing external remuneration committees with employee representation and excluding current directors.

Such changes to the institutional context require a significant rethink of current business and economic practices and government policies. Despite calls for such changes in Australia and overseas, there is little we can be optimistic about at the moment.

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