It Pays to Simplify Boardroom Compensation

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Investors should be forever grateful to Robert Nardelli, the chief executive of Home Depot who has just walked off with a $210m (£108m) severance package in exchange for years of lacklustre share price performance. For while it is galling to see failure so handsomely rewarded, he has at least demonstrated beyond all doubt how the arguments used by corporate America to justify the stock options culture are palpable nonsense.

Mr Nardelli's pay since taking office at the giant retailer in 2000 has been valued at more than $240m with much of it in the form of options. This, according to options advocates, aligned his interests with those of shareholders. Some alignment: shareholders in Home Depot lost real money, while Mr Nardelli secured a king's ransom. Alignment with or without options is anyway a pipedream. Shareholders are a disparate bunch with different balance sheets, time horizons and risk appetites. The same applies to CEOs, who have differing personal balance sheets and operate under different behavioural constraints. No pay package will ever pull off the alignment trick, whatever pay consultants - an unregulated and conflicted bunch - may claim.

Myth number two is that CEO pay determination is a market process. The reality is that the nomination and compensation committee members who secured the services of Mr Nardelli after his failure to win the top job at General Electric were a bunch of nervous, over-awed pussy cats. Because they were under pressure to deal with an awkward succession problem they decided to take a man with no retail experience at his own valuation.

Note, in passing, that these same non-executives turned from pussy cats into sheep at Home Depot's last and most notorious annual meeting when their imperial CEO told them not to attend the function that is supposed to be at the heart of board accountability to shareholders.

A third myth is that it is worth paying a fancy price to be rid of a serial underperformer. Yes, the share price jumped on the announcement of Mr Nardelli's departure. But a rewards-for-failure system sends very dangerous incentive signals. If CEOs know that they win regardless of performance, what does it do to their strategic judgment?

We cannot know whether Home Depot's controversial $6bn move into the lower margin building supplies business would have happened if the ex-GE man's pay package had included penalties for failure. But if CEOs are highly rewarded for failure, it follows that they have a huge incentive to bet the corporate ranch.

A final myth is that stock options have no cost. They do. It consists of the amount the company gives up by not selling the options to outside investors. Happily, accountancy is finally recognising this reality. Lucian Bebchuk and others at Harvard have shown that the cost has been

very significant in relation to profits. Then there are wider costs, which include the demotivation of the workforce - something at which Mr Nardelli excelled.

So what to do, to prevent so many CEOs being granted huge entrepreneurial rewards for bureaucratic performance, as at Home Depot? The American writer H.L. Mencken once said that for every problem there is a solution that is neat, plausible and wrong. Previous attempts to cap boardroom pay have proved his point, notably the move in the 1990s to legislate a ceiling on it, which prompted the explosive growth of stock options in the first place.

The least bad solution, then, is to engage shareholders and give them a UK-style vote on CEO pay. Investor activism may help. It is surely no coincidence that Mr Nardelli left after Ralph Whitworth's Relational Investors acquired an activist stake in Home Depot.

We also need to recognise that pay consultants' methodologies are still in the stone age, with heavy reliance on total shareholder return, which can reward people with stock market windfalls, and earnings per share, a malleable number to which Home Depot shifted when it suited its book. If we have to have such measurements, something closer to economic value added would make more sense.

But what is wrong, cash-poor, high-tech companies apart, with fewer options, less equity and more cash? Good old fashioned pay - now there's a thought.