WENHAM CARTER
GROUP

EXECUTIVE PAY

A Broken System?

A Wenham Carter Career Perspective

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EXECUTIVE PAY: A BROKEN SYSTEM?

2016 was the year that executive pay was thrust back into the limelight. After the well-known retailer BHS went into liquidation, much blame and public anger was directed at billionaire CEO Philip Green, who was accused of corporate mis-governance of the highest order, making careless business decisions and largely concentrating his efforts on diverting as much money as possible into his own pocket while doing nothing to solve the £571m pensions deficit. He later was later forced to plug this deficit with his own money.

Green seemed to be the centre of a perfect storm of discontent that had been brewing over executive pay amongst investors and the public in the years since the financial crisis. The BHS collapse prompted action from the House of Commons and subsequently Theresa May's government, who promised a thorough review into corporate governance and executive remuneration, to "tackle corporate irresponsibility and reform capitalism so that it works for everyone, not just the privileged few".

But it wasn't just Green making headlines. In last April's annual general meeting, 59% of BP shareholders voted against a £13.8m package for CEO Bob Dudley, representing one of the biggest shareholder revolts against boardroom pay in UK corporate history. Amid record losses for BP, Dudley had been awarded a 20% pay rise. And just hours later, medical devices giant Smith and Nephew followed suit, with 53% of shareholders voting against their executive pay package.

Concurrently, 54% of Renault's shareholders, rejected CEO Carlos Ghosn's €25m remuneration package at Renault's AGM. These votes were non-binding, meaning the boards of the respective companies did not have to take notice, and indeed in all three cases – they didn't. However they were indicative of the growing disconnect between investors and executives when it comes to what is a fair package.

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FTSE

Executive pay

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Around the same time, a report released by the Executive Remuneration Working Group (a group including some of Britain's most high profile bosses) claimed that executive pay was "not fit for purpose", and proposed a set of new changes to better align the interests of shareholders, executives and the company, lest people start losing confidence in big business. Said the group's chair, (Legal and General CEO) Nigel Wilson; "Greater transparency, clearer alignment of shareholder, company and executive interests, more accountability on the part of Remuneration Committees and greater engagement with and control by shareholders, working through company boards, are vital to restore confidence in a system widely seen as broken."

So what's the problem? For one, executive pay has been spiralling in recent years, and it seems the rise has not been matched by the same pace of growth in shareholder value or 'trickle down' wealth creation. Even though the FTSE all-share index of public companies was trading at broadly the same level as 1998, executive pay has more than trebled, according to the report by the Executive Remuneration Working Group. The story is similar in the US, where CEOs earn on average 300 times the average worker, compared to 20 times in 1965. Indeed the report found that between 1978 and 2014, inflation-adjusted CEO pay increased by almost 1,000%.

There's also the issue that pay has becoming increasingly complicated over the last few decades, encompassing complicated long term incentive plans, short term performance based rewards, salary, benefits and severance clauses. It's feared that a lack of transparency and clarity surrounding the components of executive pay has helped CEOs cheat the system for their own benefit – for example by taking short term risks to influence share prices when they have options about to vest, or trying to influence the targets they need to meet to guarantee performance related bonuses.

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Why is pay so high?

If we're focusing on the UK, CEOs here seem to be closing the gap between their traditionally higher paid counterparts in the US. This could be in part due to globalisation and increased mobility of people who are willing and able to cross borders for work. Globalisation and technological advances have also created of larger, more complex organisations entirely – almost a new breed of firm – which can be regarded as a justification for higher levels of remuneration.

We've also seen in recent years more publishing of data on executive remuneration, and the increase in 'peer benchmarking'- even a whole industry of firms dedicated purely to the increasingly complex nature of compensation consulting. This could lead CEOs to demand more, if they can see their peers in competitors or other industries are making more. And when it comes to package negotiation, what CEO would like to be seen taking an average or below average package?

Perhaps the increase in benchmarking data has contributed to an 'upward spiral' of bidding for the most talented executives. Firms are asking themselves; do we want a top 10% candidate? Wouldn't it be worth paying more for someone that could bring us greater returns? Which leads them to a simple conclusion: offer an above average package to make their offer competitive.

There is, of course the argument that high executive pay should be seen in the context of the global supply and demand for talent - something that Steve Kaplan, a professor at Chicago Booth pointed out. Scare commodities have a high price tag in any market, and being able to successfully lead a multi-billion dollar organisation is the 'diamond' of executive search. Furthermore, Kaplan found that firms with the highest paid CEOs did tend to provide above average returns for their companies, which would suggest that they were paid at least in part in line with their ability to enact positive change.

What can be done

Navigating the complexities of executive pay to ensure that firms attract the right kind of people, and incentivise them to produce the greatest return on investment, is difficult. Bill Clinton famously got it wrong in 1992 when he tried to curb the excesses of CEO remuneration by introducing tax changes making CEO salaries above $1m non-tax deductible. The changes resulted in more firms switching to performance related bonuses, allowing the 'bonus culture' to take hold.

Although the general consensus amongst investors, the public and politicians seems to be that something should be done about executive pay, not everyone agrees on the best course of action. Potential solutions include forcing firms to publish pay ratios (executive pay as a ration of the average employee pay), introducing binding shareholder votes on pay, including pay caps, or forcing Remuneration Committee chairs to step down in the face of shareholder disapproval.

In the wake of the BHS scandal and on a 'social justice' platform during the Conservative leadership election, Theresa May proposed in November 2016 a set of changes to reform corporate governance including some of the above solutions. A cornerstone policy was that workers representatives should be given a place in the boardroom, as is the case in Germany - but this idea was subsequently scrapped.

In light of May's proposals, some of the largest investors have weighed in on the debate, but again we are far from a consensus. The Local Authority Pension Fund Forum, representing 72 local government pension schemes (and overseeing assets worth £175bn), called for "binding upper thresholds for total annual pay" for executives. Pay caps have been recently announced by Volkswagen in the wake of the emissions scandal and surrounding controversy, but as a general policy they are controversial.

Fidelity International, who manages £224bn of assets, advocated annual binding pay votes, something shared by many but not all. Fidelity publicly backed Theresa May's proposals around the 'say on pay' that would have allowed BP shareholders to veto Bob Dudley's package - but the idea was met with criticism by the Big Innovation Centre, who argued that annual binding votes would have 'negative unintended consequences' and argued for a watered down version.

Forcing firms to publish pay ratios, the difference in earnings between the average worker and the top management, is backed by Old Mutual Investors (although not Fidelity). Pay ratios are problematic – indeed they were dropped as an idea by former Business Secretary Vince Cable four years ago due to the 'Goldman-Waitrose issue' - banks will appear substantially more equal than major retailers as bankers salaries are higher.

Of course, another solution could be to move to a simpler structure of remuneration – perhaps one made up of salary and shares vesting over a long period, to focus incentives on the long term. It's the short termism of performance related bonuses that can incentivise bad behaviour by CEOs. And often strict targets can create an atmosphere of mistrust between shareholders, boards, workers and executives. For example, when CEOs aren't hitting performance targets due to tough market conditions, it's easy for blame and tension to rise.

PAY AS ONE OF MANY INCENTIVES

Indeed as some commentators have argued, a system where CEOs are paid astronomical salaries and complex performance related metrics (an selection of “golden carrots”) not only may attract the wrong type of person, but may distract and even corrupt those in the role by incentivising short term gain. CEOs perform just as well in Scandinavia where the average pay is much lower – CEOs in Norway and Sweden earn only 75% of the pay of the European average, (according to a study by Hay Group) and executives there show even less desire to move around globally than their European counterparts. Executives are human beings, and just like other employees, what determines their performance, motivation and desire to move into a new role is not purely mercenary. Standard of living, good corporate culture, and a personal desire to make change; all could act as motivators apart from the money. We need to ask ourselves; are we attracting the right kind of people to lead big corporations? And is the current environment the best recipe for value creation?

EXECUTIVE PAY:
WENHAM CARTER'S CONCLUSIONS

Executive pay can be an emotive issue, tied up with concerns over widening inequality and the pervasiveness of a 'global elite'. There's political pressure for reform coming from the public but also from shareholders, concerned that executives aren't worth the high salaries they are commanding. The problem is that it's difficult to reverse the status quo, and boards as well as senior HR leaders are always trying to balance getting the best talent in but not paying over the odds for it. With the upcoming AGM season, 2017 will be an interesting and possibly tumultuous time for executive pay. The debate is far from over.

Are you interested in Executive Pay?

We'd love to hear from you. Whether it's career advice you're after, help on hiring the best talent for your team or just to chat about the industry, please contact our C-Level Search Practice team.

FOOTNOTES

1. http://www.bbc.co.uk/news/business-39118566
2. http://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/bhs-report-published-16-17/
3. http://www.theinvestmentassociation.org/assets/files/press/2016/ERWG%2520Final%2520Report%2520July%25202016.pdf
4. http://www.epi.org/publication/top-ceos-make-300-times-more-than-workers-pay-growth-surpasses-market-gains-and-the-rest-of-the-0-1-percent/?
5. http://review.chicagobooth.edu/magazine/fall-2013/are-ceos-overpaid
6. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf
7. http://www.bbc.co.uk/news/uk-politics-16688925
8. https://www.ft.com/content/d669a9ca-f77f-11e6-bd4e-68d53499ed71

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