Fair or Unfair? Getting to grips with executive pay

Wednesday 10 February, 2016

Institute of Business Ethics publishes Board Briefing for remuneration committees seeking to establish fairer and more sustainable executive pay

10th February 2016: The Institute of Business Ethics today publishes a Board Briefing aimed at helping remuneration committees identify and address challenges in awarding executive pay. Current approaches are too complicated, and the outcomes too uncertain, the report says. The decisions facing remuneration committees are often very difficult. Most try hard to do the right thing, but executive pay needs to work better or be reformed, the Briefing says.

Fair or Unfair? Getting to grips with executive pay offers both practical advice on how remuneration committees can address the challenge and some pointers to possible reform centred around the need to be clear about the value of what is being awarded and the pace at which remuneration is earned.

A good test is whether the remuneration committee can explain outcomes in a way that ordinary people can understand, which will help business in the political debate and, more importantly, help restore public trust.

The rapid increase in executive remuneration over the past couple of decades, high levels of reward for average performance, and occasional examples of reward for failure, suggests the present system in the UK does not really deliver the right incentives. Excess in executive pay has caused loss of trust among external stakeholders, including customers, sapping employee morale and causing reputational damage with policy-makers, regulators and the broader public.In IBE surveys it consistently ranks as one of the top issues the public think business needs to address.

The IBE Board Briefing offers some pointers to reform.

• Greater reliance on cash as a starting point, even though some of it should then be used to buy shares in the market which would be held for the long term

• Greater scepticism towards dilutive use of shares

• Less emphasis on short term bonuses; and much longer time horizons than previously seen.

The Board Briefing suggests that two requirements are paramount. First, remuneration committees must have a clear sense of the value of what is being awarded. There is substantial doubt whether this is the case at present, despite conscientious attempts to calculate the net present value of the packages they approve. Second, remuneration committees need to do more to justify the amount they have set.

Fair or Unfair? Getting to grips with executive pay explores seven challenges which remuneration committees face and suggests ways in which these challenges can be dealt with.

1. Does the remuneration committee know the value of the rewards being delivered?

2. Will the performance conditions really promote the desired behaviour?

3. Who really sets the bonus and long-term performance targets?

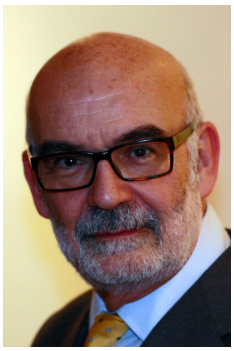
4. Does succession planning reduce the pressures?

5. Should executives receive a bonus for good management in a crisis or downturn where shareholders have lost money and jobs have been lost?

6. What account should remuneration committees take of pay and conditions elsewhere in the company?

7. Should remuneration be linked to culture and behaviour?

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Peter Montagnon, IBE's Associate Director and author of the report, said: *"Fairness and simplicity are two themes running through this IBE Board Briefing. One of the reasons why executive pay has become so problematic is that it is too complicated and the outcomes often seem quite random. Another is because it enables some executives to earn very large amounts over a short period of time, while others reap only modest rewards. That can easily drive short term decision-making.*

The link between remuneration and performance is not clear, so nobody, including sometimes the recipients, can tell what they are really being paid for. A system that operates like that is bound to attract charges of unfairness and trust will ebb away.

The more remuneration committees try to manipulate short term behaviour, the less likely they are to succeed. If their focus is on long term and sustainable growth in cash generation, they will be setting their company and its executives on a course for success."

Philippa Foster Back CBE, IBE's Director said: *"Reform of executive pay needs to be urgently discussed, and it is good to see this starting to happen, but it will take a long time to implement. In the meantime this Board Briefing offers remuneration committees thoughts on how to make the system work better. The most difficult challenge of all is probably that there are no formulaic answers. All remuneration committees have to make judgements and choices all the time, most of which require a considerable amount of courage. This will be easier for them if they approach their task with a clear set of values, which should also be those espoused by the company they serve; a proper understanding of what they are trying to achieve; and a large measure of independence."*

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To obtain an advanced press copy of the report, or to organise interviews, please contact

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EDITORS' NOTES

Fair or Unfair? Getting to grips with executive pay

IBE Board Briefing By Peter Montagnon

ISBN 978-1-908534-23-1 Price:£25

Publication date: 10th February 2016

Available from www.ibe.org.uk

12 Useful Questions for Remuneration Committees

1. What is the purpose of the package? Is it aimed at sharing success or at producing incentives to perform? If the latter, will the incentives work in the way the executives want?

2. Is the remuneration committee clear about why it has set a given quantum? What are the judgements that went in to this decision?

3. Will the executives' effort to maximise reward lead them to impose excessive risk on the company?

4. Can the remuneration committee really be confident that it understands the value of what it is handing over, especially the share-based element of the package? If not, why did it approve the package?

5. Who has set the comparator group of companies for pay benchmarking purposes? Was the process properly independent of the executive?

6. What was the direct or indirect role of the executives in setting bonus targets? Are these suitably stretching?

7. If the targets are not disclosed, are the reasons for this genuine?

8. Does the remuneration committee pay attention to succession planning so as to ensure that it has a range of options when a new chief executive is appointed?

9. Is the remuneration committee comfortable with the balance between fixed and variable pay, especially in situations where the company needs to be turned round?

10. Does the board question executives who fail to build up a significant holding of shares bought with their own money?

11. Is the remuneration committee sensitive to pay and conditions elsewhere in the company? In particular, are top executives receiving conspicuously preferential treatment at times of corporate or sectoral difficulty?

12. Are the executives rewarded for embedding a healthy culture which reduces corporate risk?

The Institute of Business Ethics is a registered charity which promotes high standards of business practice based on ethical values.

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Peter Montagnon joined the IBE as an Associate Director in September 2013. Prior to that he was Senior Investment Adviser at the Financial Reporting Council, which he joined after almost ten years as Director of Investment Affairs of the Association of British Insurers.

For two decades from 1980 Peter was a senior journalist on the Financial Times, including spells as Head of the Lex Column and in charge of coverage of the international capital markets. His last assignment, from 1994 to 2000, was as Asia Editor, responsible for the FT's coverage of a region stretching from Pakistan to New Zealand.

After graduating in Modern Languages from Cambridge University in 1972, he joined Reuters news agency as a financial journalist. At Reuters he completed assignments in Hong Kong, Zurich and Washington before joining the Financial Times.

Peter served on the European Commission's Corporate Governance Forum from 2005 - 2011. He is past Chairman of the Board of the International Corporate Governance Network and is also a visiting Professor in Corporate Governance at the Cass Business School of the City University, London, and a member of the Corporate Governance Advisory Board of the Norges Bank Investment Management and of the Board of the Hawkamah Institute for Corporate Governance, Dubai.

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