CIHRM Opinion

What is 'best practice' in executive remuneration?

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Before you try and answer, let me tell you, it is a rhetorical question. Managing the remuneration of your top employees is a complicated business. There is a lot we know. We know that companies should ensure that the remuneration of their top executives is fit for purpose by being aligned to the value drivers of the firm. The result of getting it right is, you hope, to attract and retain high performing individuals that lead the company to success and create shareholder value. Get it wrong, however, and you run the risk of not attracting or retaining the 'right' talent, a demotivated and disengaged top team and, worst of all, executives hell bent on achieving targets that destroy value. Any proposed pay arrangements must also comply with regulation design to protect the interests of shareholders. Furthermore, independent remuneration committees are expected to ensure oversight and, of course, shareholders retain the right to vote on proposed pay arrangements and in doing so have their 'say on pay' at the annual general meeting.

There is a lot we don't know, however. We don't know how to overcome completely the main obstacle in executive pay – the principal agent problem. The problem is, an innate divergence of interests between agents (company executives) and principals (shareholders) that cannot be reconciled through monitoring and controls alone because of the prohibitive costs involved. How then do shareholders ensure that executives act in their best interests? Mainstream opinion supported by a plethora of research points to the use of incentives as the most efficient and effective means of aligning executives' interests to those of shareholders. Less stick and more carrot has been the trend over the past twenty years and it looks set to continue. The Pricewaterhouse Coopers 2006 Annual Compensation report shows that executives' at risk pay is at its highest level historically, whilst fixed elements of salary, such as base pay and benefits, are remaining static or decreasing proportionately. Does this mean that shareholders interests are being represented more capably than ever before?

That is the theory at least. The reality, of course, can be perceived quite differently. Critics of the current state of executive pay contend that those same systems have resulted in unprecedented and unjustifiable pay awards. Such increases have resulted in a widening gap between executives' pay and that of employees generally. Pay systems are also becoming increasingly complex and therefore less transparent. Perhaps most significantly, there are numerous examples of dysfunctional executive behaviour and cases of 'payment for failure'. Sensationalist stories of excess, corruption and cronyism amongst the 'fat cat' elite are all reported with relish by the press and, of course, everybody has an opinion – not least your man in the street. Companies, for their part, complain about a lack of top talent and the threat from private equity firms poaching key executives and the need, therefore, for freedom to pay competitively.

Such perceived shortcomings, coupled with criticism from government for their lack of stewardship over the determination of executive pay, and the threat of further regulation to compensate, has encouraged institutional investors to become more proactive in defining what constitutes acceptable executive pay arrangements of the companies into which they invest. Institutional investor interest bodies such as the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF), acting on behalf of their members, have for some time now issued guidelines of best practice on executive remuneration. These guidelines have traditionally contained principles that institutional investors wish to see upheld by the companies into which they invest. By degree, they have become more prescriptive and detailed reflecting *de facto* what investors will and won't tolerate in proposed pay packages. Whilst not technically binding, non-compliance is a liability for any company with reputational and relational costs involved. But the proactive stance by investor bodies is not limited solely to the issuing of guidelines. The ABI in particular is very media savvy and, like others, carry their role over into the public domain, issuing statements and taking positions on behalf of their members. Companies must therefore not only observe and comply with state regulation, such as the 2003 Combined Code, but also with what is variably defined as best practice by bodies representing investors - or face the consequences.

It is fair to say that in lieu of confidence, or trust, in the ability of remuneration committees to uphold their interests, institutional investors are taking control. That they are taking control is justified – they do own collectively the majority share of the UK stock exchange after all. It is the means by which they are taking control that are giving some cause for concern, however.

Performance or compliance?

One potential problem of the prescriptive approach taken by such bodies is that it limits companies' freedom to design remuneration *best fit* for purpose. Instead, packages are increasingly beginning to reflect generic prescriptions and not the bespoke strategic challenges of the firm. In the current climate, to be different is to be singled out publicly and possibly subjected to stinging criticism. The bullish move recently by Cable and Wireless to opt for uncapped bonuses tied to performance for key executives – uncapping is certainly in contravention of the ABI guidelines - was courageous. In spite of the inevitable media attention it produced, management stuck to their guns, and broke with convention.

A brief look at the executive pay practices of the FTSE 100 reveals a picture of startling conformity. Crucially, companies compete for top talent along two principal axes – the pay vehicle (how one is paid) and the pay quantum (what one is paid). Research by the author suggests that fear of the risks of non-compliance discourages many organisations from devising innovative approaches to pay and encourages instead differentiation along the one remaining axis – the quantum. Given tight competition in this most transparent of labour markets, the result is to drive market levels upwards as companies do whatever is necessary to secure the best available talent. Indeed, would shareholders wish for the appointment of a mediocre Chief Executive? Marks and Spencer came under fire recently over the proposed package of Stuart Rose, a key architect in the turnaround of the company's fortunes. After issuing a warning, the ABI eventually approved the package but PIRC, an influential independent research and advisory consultancy, chose to reject on the grounds that it did not reflect best practice. Good governance is clearly relative and herein lies the challenge for companies.

Perception is reality in pay determination and reports in the press by bodies such as the ABI can also negatively shape not just company practice but also public attitudes to pay. Taken out of context, a quantum, with a label of excess attached to it, can only be perceived negatively. Similarly, how do we define good governance? In the case of Sir Terry Leahy of Tesco, the ABI issued an amber top warning to investors because, again, his proposed package was technically in breach of ABI guidelines. The breathtaking performance of Tesco over recent years is widely credited to the quality of its management. This raised the question of what mattered more to investors: that Tesco performs or that it complies? Shareholders ultimately voted in favour of the proposed package illustrating that performance mattered more than compliance in that particular case. What is defined as best practice, and good governance therefore, is clearly a thorny issue. An even bigger issue to confront is - *who* decides?

Better but no silver bullet

Experience suggests that there is no straight forward solution to overcoming the principal - agent problem. However, the way forward is through more and not less constructive *engagement* between companies and shareholders over issues of governance and executive pay. The point is, no one stakeholder involved can decide alone what is, and what is not, appropriate. Like the current state of politics generally, it is only through *consensus* that the interests of all are best served.

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