CIHRM Opinion

Reforming executive pay: is regulation the only way?

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The New Year's Honours List was not surprisingly devoid of bankers and politicians. The only banker recognised was Dyfrig John, former chief executive of HSBC Bank. But Angela Knight, Chief Executive of the British Bankers' Association, still believes the 50 per cent super tax on bankers' bonuses is wrong.

In the annual address earlier in the year to her members she said: "There are literally tens, if not hundreds of thousands of British jobs directly and indirectly related to banking - bringing billions of pounds in tax income. Some of this is now at risk and, although many are well aware of it, decision makers increasingly either wish to ignore it or - even more dangerously - choose not to believe it". Other financial sectors, she continued, are "waiting ready to pick up the business from the wreckage we will leave if we are stupid enough to discard a banking model which has served us well." She even warned that politicians risk sending British banking to the same fate as British shipbuilding.

Wait a minute Mrs Knight. Even before the gestating financial crisis it was clear that the system through which we govern executive compensation in publicly listed companies superseded sound personal judgement. Does it too need to be changed? Yes. The current model of executive compensation, like the banking model of remuneration, is simply not sustainable. What is clear is that the reliance upon performance based measures, financial incentives predominantly, to align executives' interests to those of investors is inherently problematic. So too is relying upon a process of oversight by weak (and partial, some might claim) remuneration committees, and investors too easily swayed by the argument of 'retention', to manage those performance based arrangements. Such weaknesses in the system have led to excesses that are not simply hard to justify in the current climate, but have left some saying that they are responsible in large part for the current crisis.

It was not always thus. According to the consultancy, Towers Perrin, 10 years ago just ten per cent of UK executives were awarded performance based bonuses. The make-up of executive compensation was vastly different. We appealed not to executives' financial self-interest to secure performance, but to their sense of a care of duty – their stewardship of the investment, employment and security provided by organisations fulfilling a central economic and social role within society.

There are high profile public sector excesses as well. Too many MPs claimed for expenses, ranging from the sublime to the absurd (a duck island in one case and the clearing of a moat in another) because they could, perfectly within the rules of the system. In hindsight, all those exposed concede that they should not have. For sure, financial self-interest should not be discounted as a reason for their actions, but a more worrying aspect to the scandal is that the Parliamentary system of claiming expenses permitted - indeed encouraged - what are now perceived to be abuses. Unchecked and unchallenged, and under the veil of public ignorance, the claims for expenses were considered perfectly legitimate practice at the time. Contrite politicians from all sides admit culpability, but blame the system that permitted that such excess, and cry for change, absolving themselves in the process of their poor personal judgement.

Whilst it is unlikely that we will abandon incentives, so entrenched are they within the current model of executive compensation determination, we must ask: how much better performing are our executives today in comparison to thirty years ago? How much more dysfunctional does the current model of incentivisation, and the governance structures put in place to manage arrangements responsibly, have to be before we are left with no alternative but to change the terms of how we remunerate our top executives?

As our MPs have so ably demonstrated, if change is to come to the system, we cannot rely upon executives, remuneration committees or even investors to achieve it. Despite increased shareholder activism and public scrutiny, change will not occur unless there is a fundamental overhaul to the system that can come only from the visible hand of regulation. Until that time, the dysfunctional behaviour of all parties concerned will go unchallenged, unchecked, all perfectly within the rules of the system.