Executive Remuneration Briefing Part 1: Ethical salaries: Do you get what you pay for?

Posted by Ben Schiller [1] on Mar 5, 2012

It seems inevitable that links between executive pay and sustainability will become stronger – and more visible

Executive compensation has been near the top of many analyses of what caused the financial crisis. A "misalignment of incentives", it was said, encouraged bankers to take excessive risks, ultimately at the expense of investors, taxpayers and the reputation of the banking industry.

Ever since, executive pay has remained a hot-button issue. The public has queried why bankers should get vast sums while the rest of society pays the bills, and many have pointed to the widening gap between top and bottom pay, especially in the US. In 2011, chief executives at S&P 500 companies got 343 times more than the median US worker. Thirty years ago, that ratio was just 42 times.

It is not only the Occupy movement that thinks something is wrong. Sir Mervyn King, governor of the Bank of England, has said that paying people too much, or for the wrong things, could imperil the economic system itself.

King told an audience of business people at an event run by the UK's Institute of Directors in January: "The legitimacy of a market economy will inevitably be challenged if rewards go disproportionately to a small elite, especially one which benefited from the support of taxpayers. Those taking decisions on remuneration, in the financial sector and elsewhere, need to understand that a market economy rests not just on incentives, but on the acceptance that the distribution of rewards is fair."

Investors, too, are often unhappy with executive pay, saying that packages do not reflect performance, or the success with which managers have dealt with risks, including those relating to environmental, social, and governance (ESG) issues. And, again, the numbers bear out the problem. A Boston Consulting Group analysis of chief executive compensation at 158 US companies in 2007 and 2008 found that 40% of bosses received salary increases in 2008, despite delivering negative shareholder returns.

Things were not much better in Europe. Shareholder returns decreased 40% on average across Germany's DAX 30 in the same period, but rates of pay fell only 21%, according to BCG.

Positive moves

Looking across the various controversies about executive pay, it is easy to build up a negative picture. However, there are also more positive developments.

For example, companies in many industries – mainly excluding banking – have started to assess employee performance against ESG metrics, and to use mechanisms to encourage longer-term decision-making.

The 2011 Greening the Green report by Glass Lewis, a San Francisco-based proxy advisory firm, surveyed almost 400 companies across nine stock-market indices, and found that 40% now link executive compensation to some form of sustainability, up from 29% in 2010.

In some countries, and in some sectors, the rates were higher. In Australia, 60% of companies on the S&P/ASX 100 index, for example, disclose some form of link. And, overall, 75% of utilities do so, including all of those in the S&P/ASX 100.

Challenged by investors and other stakeholders, companies are understanding not only that ESG issues are “material”, but also that they need to pay to ensure they are managed properly.

Investors have started to show more interest in this link between sustainability and pay, and there has been growing interest in shareholder resolutions, according to Andrea Moffat, vice-president for corporate programmes at Ceres, a Boston-based coalition of investors and NGOs.

“Investors are concerned by how companies are addressing risks and opportunities related to environmental and social issues. If you’re disclosing the link with compensation, then investors can be assured that you are really thinking about the risks in a comprehensive way,” Moffat says.

Ceres’s Roundmap to Sustainability, a best practice guide that it released in 2010, argues that sustainability should be a “core component” of compensation packages, and that the weighting should be disclosed in annual reports. Moffat says companies cannot call themselves sustainable without developing a serious pay policy, and preferably not just at the executive level, but further down as well.

Ruth Bender, an expert in executive compensation at Cranfield School of Management, says there are three drivers for companies to integrate sustainability metrics.

First, greater narrative reporting means they have to account for pay with a wider range of stakeholders. Second, as she puts it, “the outrage in the current ‘fat cat’ debate seems to me to be stronger than in previous years”. And third, more companies need to measure and reduce their carbon output, and so want to ensure that executives hit targets.

Extractive industries

Energy and extractive industry companies are leading the way so far. GovernanceMetrics International (GMI), a New York-based research firm, looked at disclosures by 4,200 companies globally, and found that almost all those linking pay to specific sustainability targets were from those industries.

Courteney Keatinge, senior environmental, social and governance analyst at Glass Lewis, says the Deepwater Horizon disaster has had a salutary effect. “BP has really been a big factor, especially for those in the extractive industries. They are really taking a closer look at accidents and environmental impacts,” she says.

“BP went from being seen as an environmentally responsible company to one that is a pariah on safety. Companies are realising that if they don’t take proper precautions then there is the potential they could end up like that.”

Transocean, BP’s drilling partner at the time of the accident, was the only company in Switzerland that reported a pay-sustainability link in the Glass Lewis study (it was the only extractive company in the SMI 20). Safety performance now dictates a quarter of bonuses awarded to its executives.

Outside the extractive industries, and outside major accidents and environmental incidents, the news is less positive. Keatinge says several companies, such as Wal-Mart, link pay to diversity targets – in 2011, Wal-Mart executives could lose up to 15% of their bonuses if diversity targets were not met. But, in general, social issues are less well covered, despite their importance to how companies are perceived.

Partly that is because they are difficult to calculate. “Those things are hard to measure, and it’s hard to tie a link back, which is why I think a lot of companies are reticent to tie certain factors in a strong way,” Keatinge says.

Many companies’ pay-sustainability links are classified as “weak” by Glass Lewis – meaning that firms did not set aside specific percentages of pay, but merely said that compensation committees “considered” the issues.

Weak links

The proportion of weak links rose from 40% in 2010, to 50% in 2011. Twenty-five per cent had "strong links" – meaning a percentage of pay was linked directly to a sustainability target – down from 29% in 2010.

Where links are "weak", Keatinge says there is no way of knowing whether the compensation committees really did consider sustainability, and what impact it had in the final reckoning.

"I'm sure there are a lot of well-meaning companies who have looked at these issues in a strategic way, and challenged executives to perform. But it is also likely that some are glossing over it a little bit."

The GMI survey found that only 25 of the 4,200 global companies it surveyed tied compensation to "hard" sustainability targets, and disclosed them.

"A number of energy companies and utilities say they measure for sustainability targets. But they don't give any detail on it. Maybe they think that saying they do it is enough," says Paul Hodgson, senior research associate at GMI.

Hodgson reckons that European companies are further advanced than US ones in "understanding the link between sustainability and share price performance or improved value growth".

But, because of different disclosure requirements, US companies are more likely to lay out their compensation schemes in detail. "The majority of companies that disclose targets are North American," he says.

Whether linking pay to sustainability actually increases shareholder value is another matter, and in fact the question has not been definitively answered. The evidence is less strong than it is for sustainability improving general corporate value.

However, a 2009 academic paper by Pascual Berrone and Luis Gomez-Mejia did find that long-term pay was effective in highly polluting industries, where public concern and the potential impacts are greatest.

Hodgson says pinpointing the part played by pay is hard, amid all the other factors. But, as a matter of common sense, it does seem likelythat incentivising sustainability would lead to better sustainability outcomes, and that it is therefore something worth doing.

Moffat calls it a no-brainer. "The way our economic system works at the moment is that people are driven by their pay check," she says.

Sustainable remuneration trends

- The 2010 **Dodd-Frank** financial reform law requires US-listed firms to disclose their **ratio** of **chief executive** to **median** worker pay.
- The UK government has proposed more "diverse boards and remuneration committees", greater **transparency** so pay levels are clear and easy to understand, and increased **shareholder** powers to improve **accountability**.
- The UK Labour party has suggested remuneration committees have **employee representation**.
- Pay consultants are a "big contributor to the problems around executive pay", according to the **Association of British Insurers**. The **Remuneration Consultants Group** published a code of conduct for the first time in 2009.
- The UK Financial Services Authority's remuneration code, which came into force at the start of 2011, requires 2,500 companies to identify key "**risk-takers**", to pay at least **50%** of bonuses in **shares**, and to defer up to **60%** for three to five years.
- Consultants **Mercer** reported in 2011 a "historic shift" in remuneration worldwide. Chief trends: longer-term and **deferred rewards**; more pay for **performance**; and

more use of a “**balanced scorecard**” approach incorporating non-financial issues into performance evaluation.

Corporate structure

How do different ownership structures affect how companies incentivise for corporate responsibility?

Last year, the **John Lewis Partnership** allocated a bonus pot worth **£194.5m**, giving equal shares to its 76,500 “partners”. They are so described as the company is owned by a trust on behalf of its employees, who all share in its profits.

Gemma Lacey, John Lewis’s CSR manager, says the company does not incentivise directly for sustainability. But it does have **performance-related pay** and annual reviews, where sustainability issues come into play, depending on the individual’s role.

In general, John Lewis prefers a “holistic” approach to performance management, and encouraging employees to “take pride in our **co-ownership** business”.

“The ethos is individual and collective responsibility for business success. Rather than being driven through by hard objectives and targets, it’s more about the sorts of behaviours we instil.”

The ownership structure helps, she thinks. “It means we can take a **longer term view**, because we’re not driven by short-term needs of shareholders. We can capitalise on the people that work for our business, and act in the interests of wider society as well.”

Rory Sullivan, strategic adviser at Ethix SRI Advisers, and a senior research fellow at the University of Leeds, is sceptical that **ownership structure** – and the different incentives that flow from it – necessarily implies better or worse corporate responsibility performance.

“I don’t think any corporate structure is perfect, and all have their strengths and weaknesses,” he says.

“The positive thing we’ve seen in recent years is that lots of companies have made **commitments** to sustainability, and investors have signalled they are comfortable so long it is clear how strategy translates to **financial performance**. They look at remuneration, and expect incentives and strategy to align. So if a company makes commitments to sustainability, investors expect to see that reflected in executive remuneration.”

Links:
[1] http://www.ethicalcorp.com/users/ben-schiller