Demonstrating Executive Pay Is Fair - The Challenge

Paul Norris, chief executive of remuneration consultancy MM&K, considers a major challenge for remuneration committees.

There But for the Grace of God

Earlier this year, we all received a stark lesson about the value of clear, unambiguous and timely communication. By his own admission, David Cameron's predicament following revelations about his participation in a Panamanian investment fund owed much to the way he handled the news, which promoted deep-felt feelings of unfairness - that there is one rule for the rich elite and one rule for others. The fall-out was damaging to his reputation and public image.
How many remuneration committee chairs of main board listed companies thought "There but for the grace of God go I." The situation they have to deal with is similar to that faced by the then Prime Minister. There is growing moral outrage at the level of CEO pay and the pace at which it is moving away from the pay of the average worker. To many (including some executives!) the link between executive pay and performance is opaque. A failure to justify executive pay, in terms other than that it is necessary to "attract, retain and motivate" the necessary executive talent, results in scepticism, lack of trust and, potentially, reputational damage.

In 2017, many listed companies must go back to shareholders for a binding vote on their future remuneration policy. The indications from voting in the 2016 AGM season suggest that, once again, remuneration committees will be in the firing line.

The Nature of the Challenge

There will always be those who criticise the fairness - or otherwise - of executive pay. They will tend to focus on:

- Amounts paid
- CEO pay relative to the average worker
- Weak performance targets
- Payments for failure.

Some of the criticisms are justified.

Remuneration committees will be aware of the complexity of the challenge. The wide variation in strategies, cultures, capital structures, risk profiles and business sectors to be taken into account when designing remuneration policy makes it impracticable to convey here the depth of the challenge. The diagram (Figure 1) illustrates the range of factors to be considered.

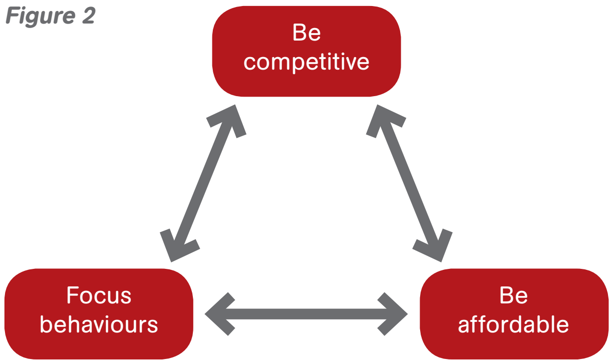
If Remuneration Committees Could Play One Card…?

MM&K's approach to executive pay is that it is a means of helping company boards deliver the company's strategy. It does this by communicating the required behaviours and the standards to be achieved and by rewarding success.

Figure 1

A challenge for remuneration committees is to design policies which take into account and balance three competing policy objectives (see Figure 2).

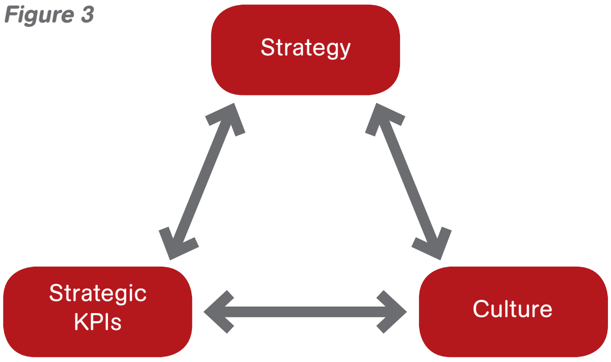
Figure 2



Few would argue with the need to pay the "going rate". Being affordable means balancing employment costs, dividends and the amounts required for re-investment. All are essential elements of a sustainable business.

Focusing on and encouraging the right behaviours is, arguably, the most challenging element. To get this right, remuneration committees need a thorough grasp of the company's long term strategy, the strategic key performance indicators, the value created if the agreed strategy is successfully implemented and the company's culture (see Figure 3).

Figure 3



As board members, remuneration committees should have no difficulty getting to grips with strategy. Listed companies are required to report on strategy in their annual reports. The Strategic Report must describe the company's financial and other KPIs to give the reader "an understanding of the development, performance or position of the company's business", according to *The Companies Act 2006 (Strategic Report and Directors' report) Regulations 2013*. But what many companies describe as their KPIs reflect historical results and should not be the only performance measures to which their long term incentives are linked.

If the remuneration committee can play only one card, it should be the ace: strategic KPIs.

Why This Card?

By identifying clear strategic KPIs, the remuneration committee:

- Demonstrates it understands the company's strategy
- Shows it understands what needs to be done and knows what signposts to look for to indicate if management are doing the right things and the company is on track
- Provides itself with a means of justifying and communicating the amounts of remuneration paid in relation to the value created.

What is a strategic KPI? Strategic KPIs look forward and indicate the progress the company is making towards its business plan goals, goals which, if achieved, should produce the financial results and positive share price performance reflected in many currently stated KPIs and incentive plan targets. For example, a retail business might look to the number of new store openings, net promoter score, growth in sales and margin. An oil company might look to its projected free cash flows and growth in asset values or reserves replacement.

Financial Reporting Council guidance goes further than the legislation in recommending that the Strategic Report should include both financial and non-financial KPIs necessary to give "an understanding of the development, performance, and position *or future prospects* of the company's business".

Historical financial measures, which by their nature look backwards, are not strategic KPIs and may not reflect the achievement of business plan goals. Nor is total shareholder return, once much-loved by institutional shareholders but waning now as a favoured measure of executive performance, a strategic KPI. TSR is a lottery when measured relative to a peer group or index and, in either its relative or absolute form, owes too much to market sentiment and not enough to the value created through direct management action.

That said, TSR remains a key measure of value for investors.

How Does This Help Demonstrate Pay Is Fair?

In his paper entitled *Fair or Unfair? getting to grips with executive pay*, published by the Institute of Business Ethics in February 2016 and reported in ECB, Peter Montagnon, associate director of the IBE, made the sage observation that fair pay does not mean low pay. The IBE paper is wide-ranging and there is much in it which echoes MM&K's approach. Large amounts of pay may be justified but are likely to attract criticism. This is inevitable. It is essential that remuneration committees are able to and do in fact communicate, internally and externally:

- How remuneration policy supports the company's strategy and
- That amounts paid are reasonable in terms of the value created.

Clear strategic KPIs, used to determine incentive payments, help to demonstrate the link between pay and performance and create a platform from which to justify and communicate executive pay awards in a clear, unambiguous and timely fashion.

Conclusion

It will not be possible to demonstrate to all that executive pay is fair. But remuneration committees must rise to the challenge.

While an exclusive focus on strategic KPIs will not provide the whole answer, it does require remuneration committees to address and rehearse the range of factors which will enable them to present a cogent argument and one which they can credibly support.

As noted, next year many listed companies will have to submit their future remuneration policies to a binding shareholder vote. In addition, regulations requiring companies employing more than 250 people to publish gender gap information are expected to come into force early in 2017 - another challenge for remuneration committees.

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