Executive pay: how much is enough?

A look at the correlation between CEO pay and company performance in SA financial services companies.

By Dr Mark Bussin, Paul Shaw and Elmiem Smit

Executive remuneration (‘remuneration’ in the United States) in its various forms has become a contentious management challenge over the past decade, as remuneration levels have seemingly grown to an incomprehensible level when viewed in the context of pay received by the ordinary employee.

CEO remuneration has attracted attention over the past years, with significant renewed interest in light of the role it is said to have played in contributing to the global financial crisis. At the heart of the issue is the perceived weak relationship between corporate performance and CEO remuneration. Pay-performance sensitivity refers to the correlation between remuneration outcomes and measures of corporate performance, and that there is not one definitive measure but rather the term refers to a broad set of measures.

Once again, proxy season has revealed some eye-popping numbers in executive remuneration packages, generating heat from shareholders, labour organisations and some reward analysts who struggle to connect the links between CEO pay and company performance. The question that arises is: how much is enough?

The CEO seems to be rewarded in most cases for corporate performance, and that there is not one definitive measure but rather the term refers to a broad set of measures. Pay-performance sensitivity refers to the correlation between remuneration outcomes and measures of corporate performance, and that there is not one definitive measure but rather the term refers to a broad set of measures.

The financial services industry

Is there a difference between CEO remuneration in the financial services than other industries, and indeed should there be a difference? The question led to a rigorous debate around the structure and underlying principles of CEO pay within the financial services industry. The evidence appears to suggest that CEO remuneration is structurally different with a greater exposure to variable pay. This prompted this present study on the link between CEO pay and company performance.

Company performance measures

The corporate performance variables included:

- Profit after tax (PAT);
- Earnings before interest, tax, depreciation and amortisation (EBITDA);
- Return on Equity (ROE); and
- Headline earnings per share (HEPS).

Other broad measures of company performance that formed part of the analysis included:

- Total-debt to total-assets ratio – a measure of the ratio of total debt to total assets and an indicator of a company’s risk profile; and
- Book value (total assets) – a measure of the company size and complexity.

Data regarding both fixed pay as well as short-term incentives was included as the key remuneration measure in the pay and performance relationship. The specific measures included:

- Fixed pay (total guaranteed pay);
- Short-term incentives; and
- Total remuneration.

Measures of CEO remuneration and data analysis

Measures of CEO remuneration include fixed pay, short-term incentive (STI), and total remuneration (TR).

Data was collected for 30 companies with a total of 49 CEOs over a six-year timeframe. This period coincided with a full business cycle, with the world economy experiencing growth in 2006 and 2007, and then moving into a recessionary phase from 2008.

Correlations were performed for the three main elements of the CEO’s remuneration package for each of the six measures for company performance over a six-year period. An accepted range for correlations is as follows:

Correlation value strengths

<table>
<thead>
<tr>
<th>Value</th>
<th>Correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00</td>
<td>No correlation</td>
</tr>
<tr>
<td>0.01</td>
<td>Very weak negative relationship</td>
</tr>
<tr>
<td>0.10</td>
<td>Weak negative relationship</td>
</tr>
<tr>
<td>0.20</td>
<td>Moderate negative relationship</td>
</tr>
<tr>
<td>0.30</td>
<td>Strong negative relationship</td>
</tr>
<tr>
<td>0.40</td>
<td>Very strong negative relationship</td>
</tr>
<tr>
<td>0.50</td>
<td>Very strong moderate relationship</td>
</tr>
<tr>
<td>0.60</td>
<td>Strong positive relationship</td>
</tr>
<tr>
<td>0.70</td>
<td>Very strong positive relationship</td>
</tr>
<tr>
<td>0.80</td>
<td>Strong positive relationship</td>
</tr>
<tr>
<td>0.90</td>
<td>Very strong positive relationship</td>
</tr>
<tr>
<td>1.00</td>
<td>Perfect positive correlation</td>
</tr>
</tbody>
</table>

The correlation between measures of corporate performance and CEO remuneration:

- The relationship between CEO remuneration and company performance;
- The relationship between CEO remuneration and company performance against each of the measures of company performance can be interpreted as:
  - Fixed Pay: shows a strong relationship between company performance (book value, EBITDA and profit after tax) and CEO remuneration measure;
  - STI: shows a moderate relationship between company performance (book value, EBITDA and profit after tax) and CEO remuneration measure; and
  - Total Reward: shows a strong relationship between company performance (book value and EBITDA, as well as a moderate relationship between CEO remuneration and profit after tax.

Overall, the relationship between corporate performance and CEO remuneration is moderate to strong, but has experienced a decline from 2006 to 2010. It is gratifying to note that the relationship between the two constructs has been strong and remains at a moderate level in spite of the global financial crisis. It is notable however that the relationship has declined and one would not like to see the relationship decline further in light of a global recovery.

A worrying observation has been the weakening of the relationship between the STI component of CEO remuneration and measures of corporate performance. In conjunction with the weakening relationship between the STI component of CEO remuneration, and measure of corporate performance, the descriptive statistics indicate a
Executive remuneration

We’re getting scary signals from Europe. By Martin Hopkins

The public debate on the quantum and ethics of executive pay is still heating up. Although the latest regulatory salvos from Europe don’t directly impact most South African companies, they reflect the intensity of the public debate on executive pay and the extent to which regulators are prepared to intervene.

The specific interventions that are of particular interest are the European Union – Bankers Bonus cap (known as the CRD IV rules), the Swiss “Minder” Initiative, and enhanced remuneration reporting and governance in the UK.

EU Bankers’ Bonus Cap (CRD IV)

As part of a new suite or rules regarding Capital Disclosure Requirements (CRD IV), the European Union has enacted legislation that severely curtails bonuses as a percentage of base pay. Although there is no cap on the total quantum of pay, the following aspects are limited:

- It implements a cap of 1:1 for the variable vs fixed pay ratio;
- In the UK this cap can be increased to 2:1 with shareholder approval;
- Implementation: 1 January 2014;
- All firms within scope of CRD3 except limited licence firms (i.e. financial services firms);
- Applies to all code staff (including those outside EU - may have implications for SA banks);
- Up to 1/4 of variable pay can be delivered in “long-term form” – discounted valuation may benefit cap; and
- To benefit from discounted treatment, it should have a 5-year vesting period, subject to clawback and delivered in shares/bail-in bonds.

The Swiss “Minder Initiative”

On 3 March 2013, the Swiss public voted in favour of the “Minder Initiative” (sometimes known as the “Fat Cat Initiative”) by a majority vote of 68%:

- All Swiss companies with shares quoted on Swiss or overseas stock exchange, governing bodies (board, exco, advisory board) and shareholders;
- There is a binding, prospective Shareholder vote on total compensation of companies’ governing bodies – Directors and members of Supervisory Boards; and
- No advance, severance, change of control or similar payments to governing bodies.

Violations against the rules of the Initiative will be subject to strict sanctions – imprisonment of up to three years and a monetary fine of up to six times the annual compensation. Although this legislation only affects Swiss domiciled companies, it indicates the attitude of the public and the regulator, and may be an indicator of increasingly onerous legislation in this area. An outright ban on sign-on and exit payments is counter to current practice in South Africa, and the binding prospective vote on executive pay is much more demanding than our current King III requirement for a non-binding advisor vote.

Enhanced remuneration disclosure and governance in the UK

Several enhancements have been promulgated in the UK, including the following:

- A “Two-part” remuneration report is required – with a forward looking policy section and a section on the historical outcomes;
- The forward looking policy will be subject to a binding shareholder vote;
- The section on historic remuneration outcomes will be subject to an advisory shareholder vote;
- A comparison between increases in CEO pay and the pay of the workforce as a whole should be provided;
- The company should provide a graph plotting the total shareholder return (“TSR”) (as a proxy for company performance) against CEO pay; and
- And provide enhanced disclosure of Service contracts, provide scenario analysis of potential remuneration outcomes versus change in profit, dividends and overall expenditure.

Martin Hopkins is a SARA Exco Member, www.sara.co.za, and Partner/Director: PwC Reward.

This column is sponsored by: