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Trends in Executive Compensation

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Executive compensation plan, no doubt, is an enabler for driving corporate objectives and ensuring alignment of interests. However, there are intricacies involved in their design and management that, if not properly addressed, can undermine their effectiveness in achieving desired objectives. The issues that those responsible for executive compensation [Human Resources (HR) and Board Remuneration Committees (RemCo)] must contend with are complex and diverse. These issues are constantly shaping the executive compensation landscape, and keeping pace with them, in today's fast changing world, can be quite demanding. The trends in executive compensation indicate the increasing attempt by businesses, shareholders, regulators, and other relevant stakeholders to strengthen the link between performance and rewards, ensure better alignment of interests and corporate governance, amongst others.

Over the past five (5) years, total CEO pay continues to grow, with larger companies paying significantly more than smaller ones. At the heart of executive compensation design is getting the pay mix right. Given their strong line of sight on business results, an increasingly higher proportion of executive pay is being made contingent on performance. The performance-sensitive portion can range between 50% and 75% of the total package, which typically comprises base pay, short term incentives (STIs), long term incentives (LTIs), benefits and perquisites. Stock Awards, ranging between 35% and 40% of the total package, are the singular largest component, while guaranteed salary and stock options are reducing. In addition, companies are beginning to adopt a combination of LTI plans, rather than a single model, for incentivizing their executives.

In respect of STI schemes, majority of companies use income-related metrics such as earnings per share (EPS), net income, operating income, EBITDA, or cost-reductions. However, there is a growing trend towards introduction of Cash Flow Metrics such as net present value (NPV), return on investment (ROI), and internal rate of return (IRR). For LTIs, there appears to be a downward trend in the use of Capital Efficiency metrics such as return on capital employed (ROCE) and return on invested capital (ROIC). Despite growing controversies around using Total Shareholder Returns (TSR), most companies are now adopting TSR for their LTI plans in order to avoid red flags. In the US, the most prevalent threshold and maximum performance levels expected for Earnings per Share and Income-related KPIs are 90% and 110% for STI plans, respectively. However, this can vary widely, depending on the type of financial measure and whether it is being expressed in absolute terms or in percentage change terms[1].

A significant factor shaping executive pay today is shareholders' voice (shareholders' say-on-pay). Even though not binding in most parts of the world, HR / RemCo are taking shareholders' opinion seriously. Knowing that shareholders will scrutinize and vote, HR/RemCo are proactively taking steps to improve on alignment of interests and sustainability in their executive pay proposals. In 2016, about 60% of BP shareholders voted against a £14m pay package for the Chief Executive in a year in which the Company reported record losses, cut thousands of jobs and froze its employees' pay. This has been the highest shareholder rebellion in the UK since the Royal Bank of Scotland's 80% vote in 2009. The Board and Remuneration Committees were, therefore, forced to review the pay package accordingly. As an emerging trend, institutional investors are now using the services of compensation consultants to advise them on their vote.

In terms of scrutiny, Regulators, Government, the Public/the Press, etc. are also constantly reacting to executives' pay. To promote transparency and corporate governance, companies are required by laws and regulations to disclose information on executive pay, corporate hedging policies, pay-versus-performance, clawback policies, severance policies, etc. to shareholders and other stakeholders. In the US, this is done via the Proxy Statement, while in the UK, companies publish the Remuneration Report. In August 2015, the US SEC finalized the CEO pay ratio rule, requiring companies to report the median of the total annual compensation of all employees (below the CEO), the CEO's total annual compensation and the ratio of the two figures.

As part of measures to enhance corporate governance and curtail excessive risk taking, companies in the global market are now required to introduce Clawback policies to provide the framework for recouping excessive / erroneously paid incentive emanating from misstated financial results. Wells Fargo has recently clawed back $150 million from its former CEO and other top executives as a result of the bank's fake account problem.

Another key feature of executive compensation is Severance and other Change-in-Control (SCC) provisions, which have become customary components relating to termination without cause / for good reason. Based on an SCC Plans Survey conducted by the WorldatWork in 2014, about 80% of the participating companies had well-documented severance polices for their employees, including Directors. The main objective is to provide the Directors with a safety net necessary to take calculated risks on behalf of the company or, in the case of an outsider, the risk to join the company.

In respect of alignment of interest, many companies have introduced share-based plans for executives. However, the fact that the executives can hedge or sell the underlying shares can undermine the alignment objectives. To overcome this defect, majority of companies (e.g. about 80% of S&P 500 in the US) have adopted mandatory stock ownership and holding requirements for executives. Under such policies, executives are required to own a significant proportion of shares, typically ranging between 5 and 6 times Base Pay, to be acquired over an average period of five (5) to eight (8) years, using Fortune 100 companies, as an example. Executives are also required to hold vested stocks for a year or two before they can begin to dispose of them.

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Executive compensation has evolved significantly over time and will continue to evolve as stakeholders continuously seek ways to ensure better alignment of interests, stronger link between pay and performance as well as promoting corporate governance. Previously implemented changes become today's lessons for enhancing the overall objective of driving corporate objectives, leveraging well-tailored and effective performance-sensitive pay programmes. The complexities and pace of developments, notwithstanding, HR/RemCo must keep up to date, in order to remain relevant.

[1] CEO and Executive Compensation Practices: 2015 Edition, The Conference Board in collaboration with Arthur J. Gallagher & Co.

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