10 minutes on...

Time to listen – responding to concerns about executive pay

pwc

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Political turmoil around the world has highlighted the concern among many that globalisation and free trade have left them behind. There's now an urgent need for "big business" to learn from this and start to rebuild public trust. One area of concern is executive pay.

Public attitudes on inequality and executive pay are increasingly negative

- There is a large gap between current pay practices and what the public believes to be fair. A recent PwC poll in the UK[1] found that two-thirds of those sampled believe that executive remuneration is too high, and 72% said it makes them angry when CEOs are being paid a lot while their companies are doing badly.
- Executive pay and inequality are significant issues in voters' minds and so of interest to politicians. The incoming UK Prime Minister Theresa May devoted significant attention to executive pay in launching her campaign for leadership of the Conservative Party.
- In Europe and the United States, attitudes towards inequality are driven more by concerns about employment prospects than by the level of inequality itself.
- Solutions need to address pay and prospects of the wider workforce, not just pay at the top. 40% of respondents to the PwC UK poll agreed with the statement that "It doesn't matter what CEOs get paid, as long as all employees get paid fairly".

Potential solutions

- In the PwC UK poll, nine out of ten people want more action on executive pay, with more power for shareholders being the most popular intervention. This intervention has largely been addressed in Australia following the introduction of the "two-strikes" rule, under which a shareholder vote on remuneration could potentially result in a Board spill if 'no votes' exceed 25% over two consecutive years.
- Caps on pay, clawbacks in scenarios of poor company performance, employee say on CEO pay, and more government regulation were the next most popular interventions desired by the public in the UK.
- In the US, the Securities and Exchange Commission (SEC) recently finalised a section of 2010's Dodd-Frank Wall Street Reform and Consumer Protection Act designed to increase transparency into executive pay by requiring publicly traded companies to publish, in addition to CEO pay figures, median worker pay and the ratio between CEO and median worker pay. By law, this data will be shared starting in 2017.
- Each of the approaches suggested above warrant further discussion, but none is without its problems. There is no magic bullet.
- And the issue of executive pay levels is complicated further by the fact that even if companies wanted to rein in executive compensation, how would they do it? It's hard to imagine a riskier move by a Board to be first to substantially reduce executive pay levels given the possible impact on their ongoing ability to attract and retain key talent, even it was initially perceived as a favourable move by the public.

Implications for Australia

- In Australia, the average ratio between CEO pay and the average unskilled worker has been found to be 98 times, which still falls way short of the ratio in the US (~350 times).[2]
- Interestingly, when the research referred to above was conducted across 40 countries regarding "what size gaps people desire", a very high degree of consistency was found at about 4.6 times with one surprising outlier - Australia at 8.3 times.
- So whilst Australians appear to be slightly more tolerant of inequities, and we're not facing the same political turmoil in Australia as some other developed countries, the underlying issues remain the same. 'Fairness' of remuneration outcomes is a topic increasingly being covered by our local media.

1. PwC UK paper *"Time to listen – we need to find a way to respond to public concern about executive pay, or matters will be taken out of our hands"*, July 2016
2. HBR, Gretchen Gavett, September 2014

- A recent report by the Governance Institute of Australia explored the concept of ethics and found that 'executive pay' was rated as one of the top 5 ethical issues in Australian business at present, along with corruption, company tax avoidance, deceptive advertising, and bullying in the workplace.[1]
- And the heat is potentially being felt most strongly by Financial Services (FS) organisations in Australia with the all too regular headlines asserting that executive and banker pay is misaligned with customer outcomes. The same study by the Governance Institute found that the majority of Australians feel that executive salaries and bonuses are actually the top two issues of ethical importance in the FS industry, even though, average bank executive remuneration in Australia as a proportion of total staff costs are lower than those in other sectors.[2]
- So, with greater scrutiny on executive pay, there is an immediate need to address the key issues of fairness, complexity, and misalignment.
- We believe there are a number of actions that companies can take now to help rebuild public trust in business, to mitigate the risk of getting executive pay 'wrong', and to address issues of public concern before these issues are addressed for them through additional and often counter-productive regulation (see right box).

Actions for companies

- Remuneration Committees need to be prepared to make tough decisions and set tough targets. Bonuses close to the maximum should only be paid for unambiguously outstanding performance.
- Furthermore, on-target annual bonuses should not be easily earned. The percentage of ASX100 CEOs receiving less than 75% of their target incentive has not exceeded 30% over the past three years[3]. These payments need to be seen by the public as truly variable, and to be varying in relation to transparent performance outcomes.
- Companies should develop a set of fair pay principles. And remember, that perceptions of 'fairness' usually depend on both a fair *process* and a fair *outcome*. These principles should cover the company's approach to wages across their business and supply chain, and to executive pay in the specific organisation but also in a broader societal context.
- Companies should ensure they have a robust and up to date People and Reward strategy, that covers modern and emerging issues, including labour displacement by technology, and diversity and inclusion strategies.
- Companies need to redouble efforts to communicate the benefits of positive business outcomes in terms ordinary people understand. Most company reporting is heavily directed at shareholders, with benefits to society too often lost in business jargon.

In our view this is a critical time for all those involved in executive pay. All of us need to ask one simple question of each decision we make: ***Will this decision enhance or erode the stock of public trust in business?***

1. Governance Institute, Ethics Index July 2016
2. Jain, Guo, and Lin (2014) *"Bank Fundamentals, Executive Compensation and Public Perception of Banks in Australia"* Economic Papers: a Journal of Applied Economics and Policy 33 (3): 220-232
3. PwC, *"10 minutes on…Executive remuneration trends: making pay while the sun shines"*, February 2016

How can PwC help?

To have a deeper discussion about these issues, please contact:

Sydney

Emma Grogan
Partner
Ph: (02) 8266 2420
Email: emma.grogan@pwc.com

Debra Eckersley
Partner
Ph: (02) 8266 9034
Email: debra.eckersley@pwc.com

Daniel Geard
Director
Ph: (02) 8266 0725
Email: daniel.geard@pwc.com

Cassandra Fung
Director
Ph: (02) 8266 2183
Email: cassandra.fung@pwc.com

Melbourne

Andrew Curcio
Partner
Ph: (03) 8603 1685
Email: andrew.curcio@pwc.com

Elizabeth Stephens
Director
Ph: (03) 8603 4844
Email: elizabeth.stephens@pwc.com

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