

Executive Pay

Rev. Patrick Gerard

In 2004 I started to research executive pay in detail. I became more and more disappointed in what I found. Coming from a business background, I was very ready to believe most of the standard business arguments used to justify high executive pay. But as I looked deeper, I realised that actual practice in the field of executive pay had very little to do with the standard arguments.

For example, I often heard the argument, 'We need to pay well to attract and retain the best executive talent in a competitive market.' But the market in executive talent is not competitive in the economic sense; certainly there is no market price at which 'supply' balances 'demand'. The 'supply' of future executive talent is firmly under the control of the existing chief executives, and is not affected by how much they earn. Further, this argument cannot explain why such huge sums are paid to departing directors. The high level of executive pay is far better explained by the power of the incumbent chief executives rather than by any market considerations.¹

Shareholder value

Similarly I often heard the argument, 'This additional incentive scheme has been introduced to increase alignment between the interests of directors and shareholders.' What I found was that a remuneration committee that is genuinely serious about increasing the alignment of director and shareholder interests always has much better options than introducing a new incentive scheme. For example, it would be far more effective to align all existing incentive payments with long-term growth in shareholder value. It would be more effective to move from defined benefit to defined contribution pensions schemes.

The introduction of a new incentive scheme is much more believably explained by the desire to pay more than it is by alignment with shareholder interests.

So, if high executive pay cannot be explained or justified by the traditional arguments, how has it come about? One factor has undoubtedly been a situation in which almost all companies aspire to pay their directors at above median rates. Of course, by the mathematical definition of median, it is only possible for half of all companies to achieve this, but this does not seem to discourage most companies from trying!

Another factor is the business model of remuneration consultants. The consultancy sales pitch - 'Hire me and I will increase your pay' - is compelling. The consultancies who work hardest at justifying higher executive pay have been the ones that have thrived and become most influential.

Inequality

So why should we be concerned about excessive executive pay?

Well first of all, it is giving rise to a new form of inequality. In the US a CEO often earns about 400 times what the average employee earns.² We have not yet reached this extreme in the UK, but we are moving in that direction.

Secondly a huge share of all new created wealth is accruing to a very small number of individuals through executive pay. Between 1996 and 2001, real median earnings in the US rose by 11 per cent. Over the same period, the earnings of the top 1 per cent earners rose by 121 per cent. Economists are becoming concerned that the economic justification for creating new wealth is undermined if the new wealth is shared so unevenly.³

Thirdly, whereas we can have some confidence that entrepreneurs who get rich through company dividends are creating wealth for the rest of society, we cannot have this confidence in the case of executive pay. For example, the buyers of MG Rover extracted £47m in directors' fees before the business collapsed in April 2005, without ever creating a viable business plan for the company.⁴

Fourthly, badly structured executive pay often creates damaging incentives. Pay structures can easily promote individualism, a focus on short-term results, and a focus on presentation rather than substance.⁵

Fifthly, excessive executive pay contributes to a culture which equates personal success with high pay, irrespective of the success of the operation being managed or its impact on other stakeholders. Such a culture values people according to what they take from society, not what they contribute to it, and this is disastrous for the public good.

Change in culture

So what can we do about executive pay? Well, with regard to the way that executive pay is structured, it is relatively easy to make the business case for better structures.⁶ With regard to the level of pay, Competition Law might provide a way forward,⁷ as might a legal analysis of the concept of Fiduciary Duty.

More attention to executive pay by pension fund trustees would also help. Personally I think that there is some scope for improvement driven by regulation, but real progress depends on a change in culture on the part of the people who make the decisions. Such radical renewal of hearts and minds is never easy, but this is the field where the Church makes its contribution.

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Notes

1. Lucian Bebchuk and Jesse Fried, *Pay without Performance*, Harvard University Press, 2004.
2. William McDonough, Chairman of Public Company Accounting Oversight Board, testimony to US Congress, June 2004, *Financial Times*, 24/08/04, p.15.
3. Martin Wolf, 'A new guided age', *ft.com*, 25/04/06.
4. *Financial Times* front page, 22/04/05.
5. Patrick Gerard, *Performance and Reward*, Matador (Leicester), 2006, pp.28, 60, 61.
6. Gerard, *Performance and Reward*, chs.1-10
7. See <http://performanceandreward.blogspot.com/2006/04/competition-law.html>.