Executive compensation
The call for a change in mindset and practices

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Executive compensation is firmly on the social, political and regulatory agenda today. The level of executive pay has been constantly rising for decades, particularly in comparison with the average workers' pay.

There is a debate over whether such high executive pay is justified by the skills and results of business leaders[1] or a socially unacceptable phenomenon[2] that should be controlled. Moreover, there is a question mark over whether typical remuneration package components such as share options are effective in encouraging long-term decisions[3]. Furthermore, the economic crisis and government bailout were a strong catalyst in this debate and led governments and regulators to act under the social pressure[4].

This raises a number of questions, but three are particularly interesting: Why are executive remuneration practices at the top of the agenda? What are the trends influencing executive compensation? How do companies adapt to these trends?

What's the problem?

An executive's remuneration package typically comprises a fixed salary, together with a range of benefits in kind, a performance bonus and long-term incentives (such as shares and options). The package should be balanced between the fixed and variable parts, and in terms of payment in cash or financial instruments.

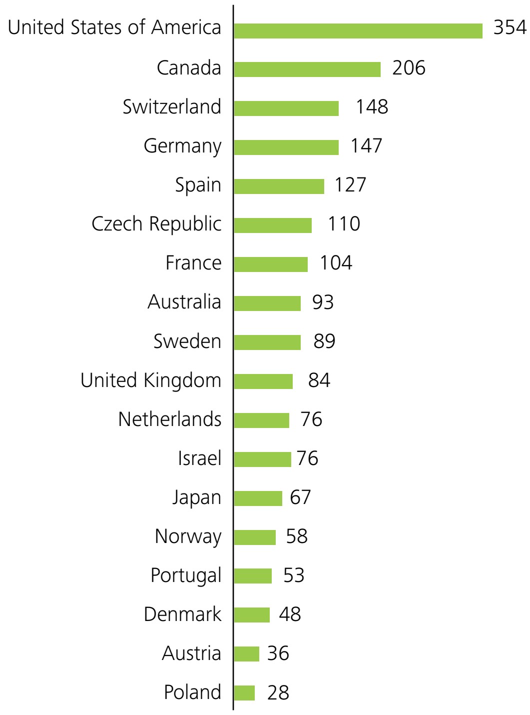
The structure of the package is at the top of the senior executive's agenda, because the package is a key factor in encouraging the expected behaviours, while adequately rewarding and recognising performance. The proposed remuneration should be sufficiently attractive, while allowing for flexibility as regards company results and individual performance.

For decades now, and even more so following the financial crisis, three main aspects of executive remuneration practices are being challenged: (1) the significant gap between top remuneration and the average worker's salary, (2) the constantly rising levels of pay, and (3) the relevance of rationales used to determine the individual components.

The gap between top remuneration and the average worker's salary—both the OECD[5] and AFL-CIO[6] point out that significant remuneration gaps are sources of future social and political instability. Indeed, the actual gap between top managers and employee salaries is not static and is generally on the increase (Fig. 1). For instance, in the United States, a top manager receives on average, 354 times more than the average employee. This ratio is 1:148 in Switzerland, 1:147 in Germany, 1:127 in Spain, 1:104 in France, 1:67 in Japan, 1:58 in Norway and 1:48 in Denmark. The European country with the smallest gap is Austria, with 1:36.

1 Valérie Lion (26 March 2013). Salaire des patrons: halte aux idées reçues. http://lexpansion.lexpress.fr
2 Sarah Rainsford (2011). Spain's 'Indignants' lead international protest day. BBC
3 The Economist (13/2/2014.) Share options: The law of unintended consequence. www.economist.com
4 Jean-Jacques M'U (2012). Nous, Indignés… occupons le monde ! ABC éditions, Paris
5 OECD (2013). Growing risk of inequality and poverty as crisis hits the poor hardest. http://www.oecd.org
6 AFL-CIO (2013). CEO-to-Worker Pay Ratios Around the World. http://www.aflcio.org

Figure 1: The salary gap between top executives and employees worlwide



Source BLS, OCDE & AFL-CIO

	Average remuneration	
	Top executives	Employees
United States of America	€9,072,322.00	€25,637.00
Canada	€6,441,047.00	€31,267.00
Switzerland	€502,504.00	€37,179.00
Germany	€4,375,458.00	€29,765.00
Spain	€3,255,937.00	€35,446.00
Czech Republic	€1,597,882.00	€14,526.00
France	€2,934,332.00	€28,215.00
Australia	€3,095,730.00	€33,287.00
Sweden	€2,485,161.00	€27,923.00
United Kingdom	€2,781,225.00	€33,110.00
Netherlands	€2,646,429.00	€34,821.00
Israel	€1,619,937.00	€21,315.00
Japan	€1,742,390.00	€26,006.00
Norway	€1,888,051.00	€32,552.00
Portugal	€891,941.00	€16,829.00
Denmark	€1,618,291.00	€33,714.00
Austria	€1,160,305.00	€32,231.00
Poland	€415,830.00	€14,851.00

Currency conversion on 22 November 2013 by Le Figaro
(Le Figaro, 25 November 2014. Le grand écart des rémunérations entre salariés et patrons à travers le monde. http://www.lefigaro.fr
at 1$ = 0.74€

The increase in executive remuneration levels—in addition to the gap, top salaries are continuing to increase. For example, between 1998 and 2008, the salaries of top managers of CAC40 companies rose by 18%, while stock options and bonus components increased by more than 120% (Fig.2)[7].

Rationales for defining remuneration levels—on the one hand, companies argue that high remuneration is necessary to ensure competitiveness on the international market for top managers. However, critics point out a disconnect between remuneration levels and results[8], along with insufficient transparency in the criteria used to define remuneration levels. Meanwhile, citizens or employees are increasingly discomfited by levels of executive pay, especially when companies are losing money or share value[9].

As a consequence, traditional executive remuneration practices are increasingly being questioned, and social, political and regulatory pressures are creating a significant shift in the mindset and practices applied to executive compensation.

Towards greater control and regulation

A number of initiatives and pressures coming from the supranational, governmental, corporate and social spheres are favouring greater control and regulation of executive compensation practices. This external pressure is influencing executive compensation in various ways.

Supranational regulatory initiatives—in the financial sector, the Capital Requirements Directive (CRD), introduced in the wake of the financial crisis, more control and regulation of the remuneration of material risk takers, especially executives. The key requirements

7 Le Nouvel Observateur/Jean Gatty (3 March 2012). Pourquoi les salaires des dirigeants du CAC 40 ont doublé en dix ans. http://rue89.nouvelobs.com
8 Valérie Lion (26 March 2013). Salaire des patrons: halte aux idées reçues. http://lexpansion.lexpress.fr
9 Louis Vergeat (3 July 2013). Classement des salaires des patrons: le top 5 de ceux qui les ont le moins mérités. http://www.atlantico.fr

focus on increased transparency and governance, as well as risk alignment of remuneration. Initially applied to banks and credit institutions, the scope of the regulations is being progressively expanded (this now includes the investment sector, with the AIFMD and UCITS directives). The regulations are also becoming more restrictive. As an example, CRD IV introduces the requirement for a 1:1 ratio of variable versus fixed remuneration. This requirement can only exceptionally be extended to 2:1, under certain disclosure conditions.

Government initiatives—European countries have adopted national legislation to regulate executive compensation practices. In 2013, France adopted a law introducing a 75% tax on the highest salaries[10], which also banned stock options and limited bonuses. Following this trend, the Netherlands, Spain, Sweden, the United Kingdom, Italy and Germany[11] have limited or are going to limit the highest remuneration using a wide range of regulatory and other measures[12].

Figure 2: Top executive pay at CAC40 companies 1998-2008 (€ million)

Company	Salary of the executive committee		Number of members in the executive committee		% increase
	1998	2008	1998	2008	
Accor	3.9	8.9	12	13	120
Air Liquide	5.9	9.9	7	11	29
Alcatel	7.1	9.1	11	7	55
Alston	1.7	6.0	11	5	399
Axa	40.2	18.4	22	19	-51
BNP	6.8	3.2	23	4	20
Bouygues	8.8	15.6	15	13	91
Capgemini	7.5	20.8	15	28	110
Carrefour	4.3	7.0	9	5	129
Danone	7.4	17.5	11	11	136
Essilor	2.5	7.4	12	19	133
France Telecom	2.5	6.6	9	9	161
Lafarge	6.1	8.7	15	11	70
Lagardère	2.4	8.8	12	7	394
L'Oréal	9.9	23.8	10	13	107
LVMH	17.2	51.0	20	15	239
Pernod	3.5	13.7	10	17	202
Peugeot	5.0	9.3	14	16	75
PPR	3.1	25.4	7	12	502
Renault	3.1	7.3	7	7	135
Saint-Gobain	11.0	13.4	22	18	14
Sanofi	9.6	30.1	21	22	243
Schneider	4.2	12.1	10	16	123
Société Générale	11.2	9.1	29	16	5
STMicroelectronics	7.5	16.0	18	28	76
Total	5.5	18.0	16	28	156
Vivendi	10.2	10.1	17	6	63
				Median	**120**

Source: Le Nouvel Observateur/Jean Gatty (3 March 2012). Pourquoi les salaires des dirigeants du CAC 40 ont doublé en dix ans. http://rue89.nouvelobs.com

10 BBC (29 December 2014). France's 75% tax rate gains approval by top court. http://www.bbc.com
11 There is a long-running debate in Germany (which started in 1979 with the Geßler Commission) about the position of banks, which this year led to a call for capping executive compensation at listed companies.
12 CGA/AFP (4 March 2014). La Suisse «inspire» le premier ministre français. http://www.20min.ch

Corporate initiatives—companies are also taking measures to redefine their executive compensation frameworks and governance. For instance, Nestlé plans to adopt a new pay system for its top management in 2014, whereby the shareholders' meeting votes on its top managers' total compensation (fixed and variable) for the following year[15]. This represents a significant shift in power and redefines the relationship between the principal and the agent[16]. Theoretically, shareholders will now have considerable power in relation to the board of directors and top executive remuneration. Moreover, this should reduce high bonuses and potential abuse.

Citizen initiatives—the most representative citizen initiative is the Swiss federal initiative 'against rip-off salaries' of 2013, which was praised by the European Union[17]. This initiative aims to control the executive pay of companies listed on the stock market, and to increase shareholder power in the area of corporate governance. In fact, this initiative partly reflects developments in the United States, namely the Dodd-Frank Wall Street Reform Act 2010 §957, which banned brokers from voting on their clients' money, and the Stewardship Code 2010 in the United Kingdom, which placed a duty on financial intermediaries to disclose their voting policies and make use of voting power.

Whether generic or country and sector specific, all these initiatives are strongly influencing current and future executive compensation practices. How do companies cope with these key changes in practice?

Mixed results and painful implementation

Nonetheless, it would also be fair to say that citizens and governments are leaning towards accepting some of the economic arguments. Indeed, some initiatives have been shelved or their implementation postponed.

For example, the 2013 Swiss federal popular initiative '1:12' which aimed to cap salaries[18] using a 1:12 ratio has been rejected. The initiative demands that the highest salary paid by a company should not exceed 12 times the amount of the lowest salary paid. The aim is to restrict the salaries of the top managers and top executives. In addition, we can also mention the abandonment in France of the idea of regulating corporate governance and top manager salaries[19, 20].

Although the trend is clearly towards increased control and regulation, the actual implementation of the various initiatives is proving difficult and painful, including at the political and corporate level. In fact, the regulatory initiatives do not seem to have translated into practical results so far. While the tendency is to cap variable remuneration in the financial sector, UK and U.S. bankers saw their variable remuneration levels increase by almost 50% between 2012 and 2013[21], according to the MEP Philippe Lamberts.

Regulators are aware of these challenges, and are therefore highlighting the need for enforcement measures (e.g. MiFID) to ensure that remuneration policies adhere to transparency, investor protection and risk alignment principles—and that they also are effectively implemented. Of course, changing practices is easier said than done.

In parallel, companies are finding it difficult to understand and interpret complex and sometimes overlapping guidelines, and to agree on practical ways of implementing them. In particular, they are concerned by the related additional administrative complexity and implementation costs, as well as a loss of attractiveness on the employment market.

13 BFMTV (11 Mach 2014). Salaires des dirigeants: Nestlé anticipe la limitation. http://www.bfmtv.com
14 See Agency Cost Theory [Jensen, Michael C. & Meckling, William H. (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. Journal of Financial Economics, 3(4): 305–360]
15 RTS (9 March 2013). Séduite par l'initiative Minder, l'UE veut limiter les hauts salaires. http://www.rts.ch
16 By salary, the initiative means the amount of benefits in cash and in kind paid in connection with gainful employment.
17 Les Echos (23 May 2014). Pierre Moscovici: "Pas de loi sur la rémunération des patrons". http://www.lesechos.fr
18 Denis Thomas (24 May 2013). L'Etat renonce à encadrer le salaire des grands patrons : On a eu très peur ! http://www.agoravox.fr
19 Trends.be (14 March 2014). Philippe Lamberts continue de faire trembler la City, ses banquiers et leurs bonus. http://m.trends.levif.be

Conclusion

The pressure on high salaries is not going to ease, and we are likely to continue to see bad press. Although governments and citizens seem willing to give companies some time to find solutions, they will keep a close eye on companies' practices and actions. In this sense, businesses should be prepared to adapt and face further tightening of regulations.

Despite this pessimistic picture, there are solutions. This means anticipating forthcoming changes and being creative in terms of total rewards and employer brand to make up for lost attractiveness in terms of monetary incentives. In other words, companies need to work on their compensation, benefits, work-life balance, performance and recognition, development and cross-board career opportunities. Moreover, corporations can also use tax optimisation strategies to enhance the position of top executives.

Put simply, there is plenty of scope for overcoming the difficulties in this area and adopting an organisational strategy that will gain respectability. This new mindset requires a move from pure compliance to the inclusion of the new remuneration paradigm in the corporation's strategy.

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