Executive pay bubble – a myth or a reality in SA?

A paper in the March 2012 HBR argued that American capitalism had been transformed over the last three decades by the idea that financial markets are suited to measuring (executive) performance and structuring compensation.

The article based a large portion of it's arguement on the basis of a CEO : "average employee" salary ratio moving from +-30 to +-400 over the (30 year) period, an "executive pay bubble"

Irrespective of how you construct this ratio, South Africa has one of the highest income differentials in the world. Articles to this effect appear in our press on a weekly basis. This begs the question, are we experiencing an executive pay bubble?

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US picture

Every measure would indicate an unsustainable trend

Even more extreme if top 100 CEO's are used as a reference point

Ave 2005 top 100 CEO $54,413m

35.8 x

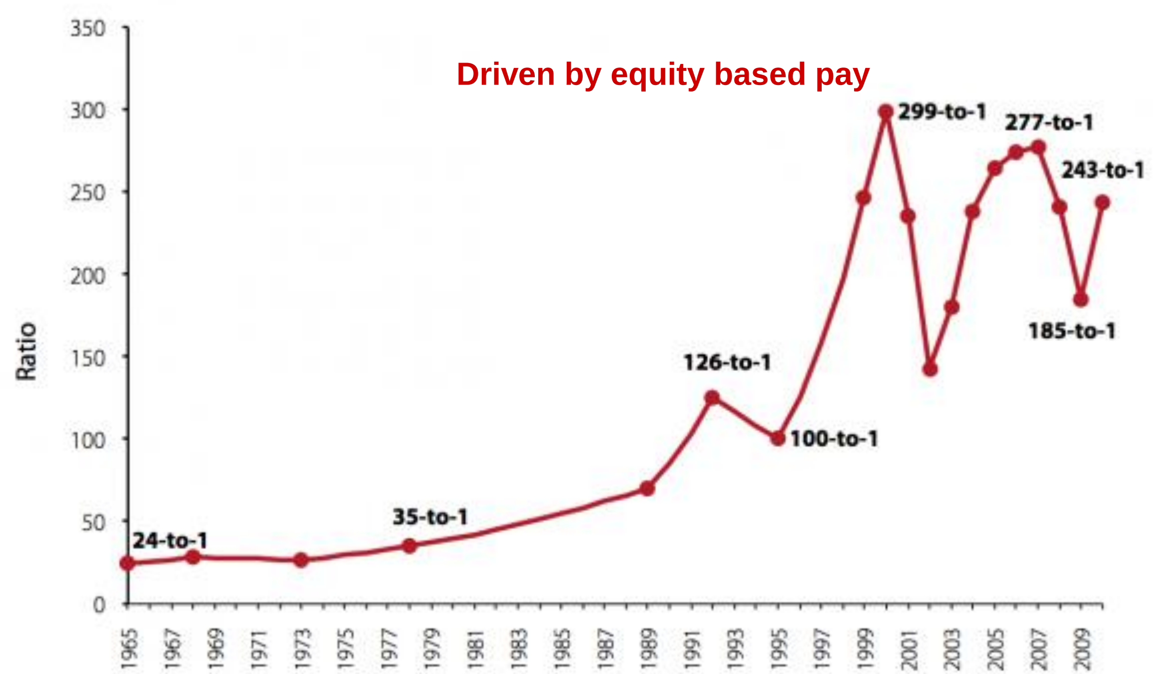
Ave 1970 top 100 CEO $1,520m

Ave 2005 workers salary $49, 000

1.24 x

Ave 1970 workers salary $39, 400

Ratio of average annual CEO compensation to average worker compensation, 1965–2010



SOURCE: Adapted from Lawrence Mishel and Josh Bivens, *Occupy Wall Streeters are right about skewed economic rewards in the United States*, Economic Policy Institute Briefing Paper #331, 2011.

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Bubble, what are the characteristics?

1. **Rapid increase in price without a commensurate move in the intrinsic value of the underlying asset**
2. **Initially demand out strips supply but speculation drives the disconnect**
3. **Intrinsic value is often only determined in retrospect, which is why bubbles are associated with “crashes” (after which intrinsic value is “obvious”)**

Bubbles are an indication of an inefficient market

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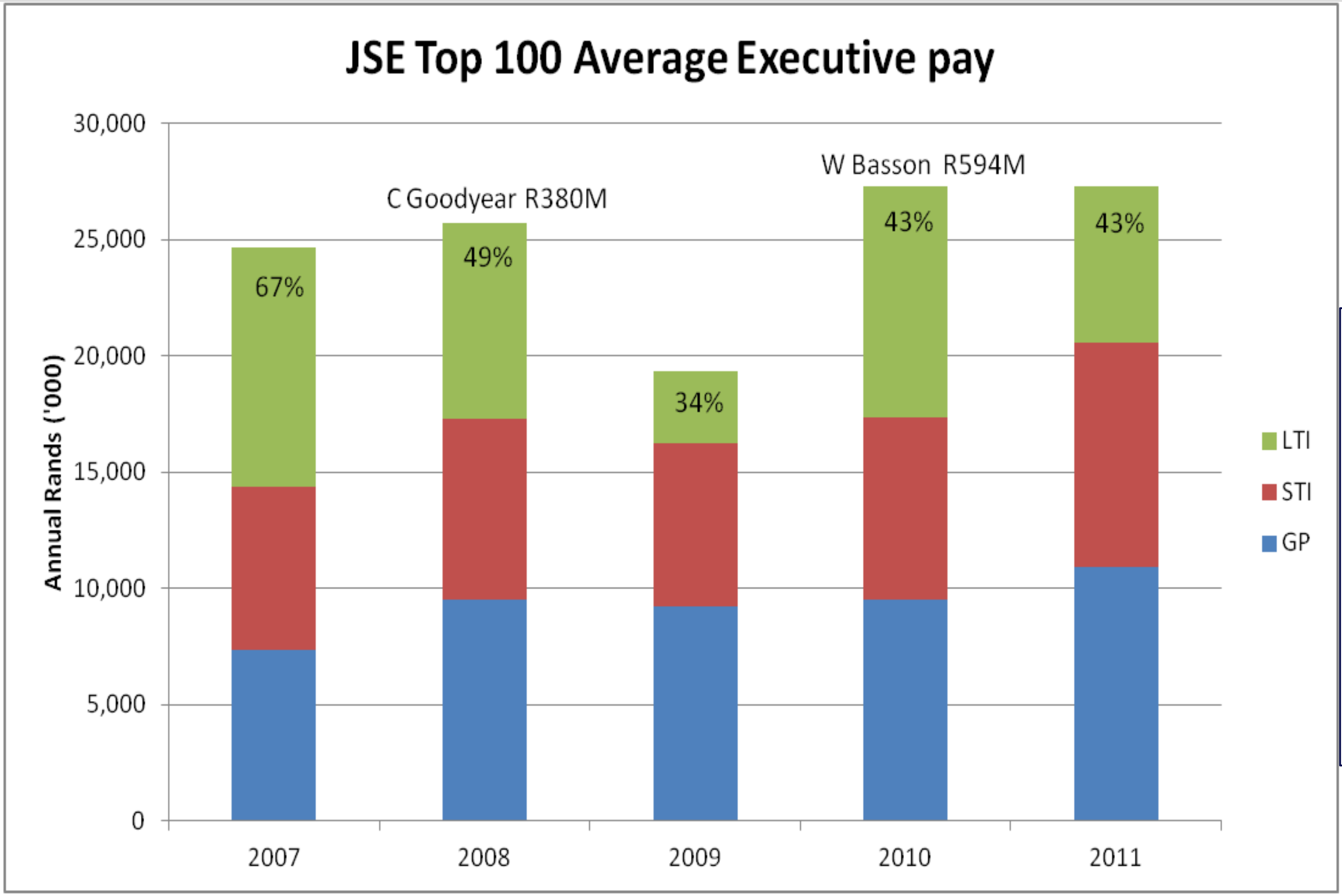
SA Picture

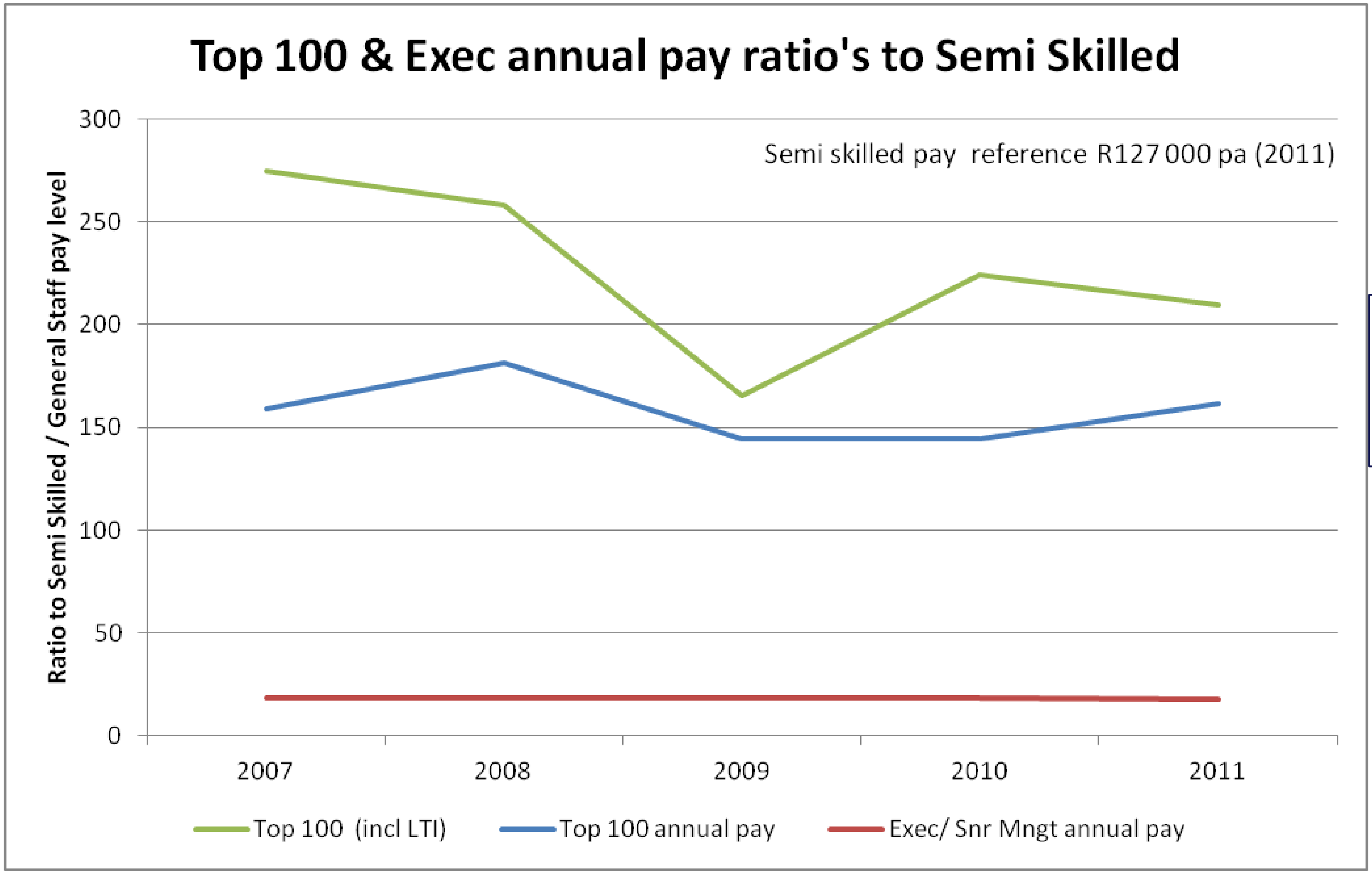


US CEO pay is primarily made up of variable elements, 4-5 x the fixed portion.

The structure of SA pay is much more fixed than theirs

Source: Who owns Whom (Pty) Ltd

SA Picture



SA Ratio's are high but the trend is relatively stable

Note: this is NOT average workers pay nor is it average CEO pay

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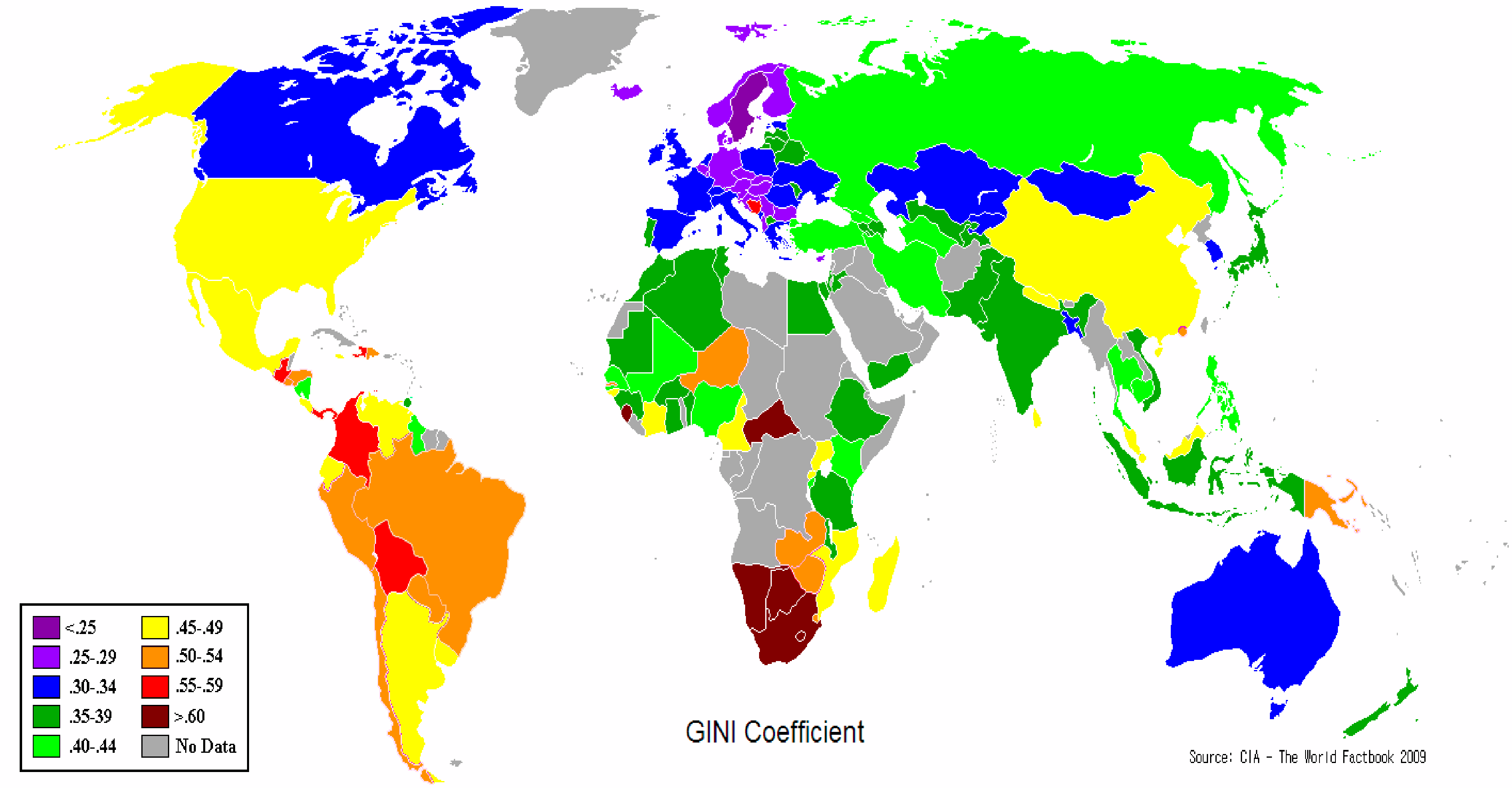
The ugly truth about southern Africa



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Conclusions

We do not appear to be experiencing the characteristics of an executive pay bubble …….

However …………. whichever way you wish to measure it …………

we have extremely high levels of income inequality in South Africa

Low life expectancy, depression levels, violence, illiteracy, obesity, teenage pregnancy, poor education outcomes, in fact most measures of social and individual well being are strongly correlated with inequality, rather than how wealthy a society may be.

In light of events in our country, many would consider this inequality to be unsustainable, so, what is our response to be?

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Possible pressures

- **Legislation** ? - Capping pay is a blunt instrument shown to be ineffective and to have unintended consequences
- **Hightened executive taxation**? – examples elsewhere in the world have shown this to be counter productive, especially in the longer term, and unsustainable
- **Calls for self regulation**? – an oxymoron, particularly where opportunity and means coincide
- **Market forces**? – allow the law of supply & demand to prevail. This assumes an efficient market, which is not the case in executive ranks
- **Ethical and / or moral arguments**? – in a country beset by high levels of corruption .... probably not a likely option
- **Strikes and social unrest**? – unless an “Arab spring” likely to be short lived, everyone loses but to the greater detriment of the poor.

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Assumptions

- Income inequality is a multifaceted problem, executive remuneration is but one of many dimensions, it cannot contain the complete solution
- Managerial & investment capital may be the most important ingredients in modern capitalism and such talents should be richly rewarded when they are evident
- Executives are no more greedy or unethical than any other group in society, like all people they are seen as successful when they maximise their opportunity
- The income disparity in the country is longstanding, extreme and has not reduced since 1994, it has been the South African norm
- The National Planning Commission has released, and cabinet endorsed, the National Development Plan. It contains a number of sensible and achievable societal objectives
- This is not a uniquely South African problem, but we need to take the lead

Proposed responses

- **Focus on getting variable pay to work, properly** – current schemes are, far too often, not valid or well connected to performance (BHP Billition and Investec CEO's forfeiting 2012 bonuses is an implicit admission of this)
- **Remove asymmetrical incentives** – sharing in the gains but not in the losses leads to high risk and short horizon decisions (options and SARS can cause this, beware of "outperformance")
- **Align private rewards with societal objectives, not just profit** - This can start close to home, eg living conditions of staff
- **Focus on the long term** – this is not a single year endeavour, structural correction takes time, otherwise it is called a revolution
- **Promote transparency** - it's the foundation stone of good governance

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Remco actions to improve governance

- **Assume oversight for variable pay designs, and their results!** – this is the highest risk area in executive pay and requires the most governance
- **Model the lifetime value (scenario's) of variable pay** – it is not enough to simply approve estimate on the basis of Black Scholes
- **Require transparent measures of performance** - base incentives on long term performance measures to reduce short term risk taking
- **Focus on the long term** – incorporate sustainability requirements, even on STI's
- **Remove asymmetry in design** – or at very least limit the degree of skewness, particularly in commodity driven businesses
- **Question the idea of retention incentives for executives** – surely it should be all about performance at this level?
- **Embrace Say on Pay** – because executives have the opportunity and the means to influence variable pay determinants there has to be a "check by owners"

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Cautionary note

If we follow the practices of American executive or financial sector incentives we could to great harm :

Financial market based compensation (equity based pay) cannot be relied upon in SIMPLE ways to compensate individuals because

- it doesn’t disentangle skill from luck (specifically in commodity based businesses)
- windfalls lead to an attitude of entitlement
- incentive design is asymmetrical (share in the gains but not the losses)

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Benchmarking as a design input to compensation plans is inflationary

Thank you