Executive pay and how the fundamentals work

By Chris Blair

15 Jul 2022

Executive pay attracts a lot of attention and usually for contentious reasons. Whether it is an absurd looking quantum being paid out or a bonus that has triggered a payout in a time when the company is experiencing difficulty, these types of events frequently make headlines. The story of the quantum that is paid out is often told without the history of how it was accrued, which in essence would only reveal part of the story. That is not to say that irrational payouts should not be scrutinised as a matter of public interest but rather we should evaluate the payout against the design principles before we can get the full story.

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Typically, executive pay consists of three pay elements:

- Total guaranteed package (TGP)
- Short term incentives (STI)
- Long term incentives (LTI)

Each of these three elements play a vital role in the attraction, retention, and motivation of executives.

Total guaranteed package

TGP is the value of the guaranteed portion of pay and does not have pay conditions attached to it. It is the minimum salary that can be earned even if STI and LTI are zero. This serves as an attraction tool for companies as the executive can plan a certain level of safety around their finances by knowing the minimum they will receive even if the company experiences poor performance. For the ambitious executive (and I would like to believe most are ambitious), this should be seen as a safety net and a worst-case scenario as they would seek to return the levels of company and individual performance that results in them meeting their key performance indicators (KPIs) within their key performance areas (KPAs). If the STI and LTI are well designed, the fulfilment of these KPAs and their KPIs should translate into economic value for the executive.

Short term incentives

This is a remuneration element that seeks to link the performance of the individual to the performance needs of the company for a period of typically 12 months or less. Short term targets are set and the specific payouts are set at varying levels of performance for the executive. This serves as a motivation tool for the executive to focus on specific tasks and areas in order to meet the short term needs of the business. These tend to be cash settled but may contain a portion of pay that is deferred (paid out at a later stage) as cash or shares. This deferral can be seen as a medium-term instrument that adds to the retention proposition for the executive as they will typically not walk away from these deferred payments if they have not yet reached their exercise/settlement date. The deferral also allows the company to claw back STIs awarded if there is any type of malfeasance that arises before the deferred amounts are settled.

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Long term incentives

This is quite possibly the most contentious element of executive remuneration as these payments can not only accrue over time (if they have vested but not been exercised) but they are often paid in shares and can lead to unintended consequences if the share price soars or drops. The version of this that typically finds its way into the media is a bulk sale of shares (probably at a very attractive price or else the executive wouldn't sell) accrued over a number of years that results in quantum that is reported correctly but the interpretation by the public is that was accrued in a single year which is often not true. LTIs seek to achieve two things:

- Retain an employee as the shares that they have earned but not yet vested (can't be cashed in yet as the vesting date has not arrived) will usually lapse when the employee leaves the company.
- Tie the fate of the business to the remuneration fate of the executives. In other words, the payments are paid out only when the desirable outcomes as laid out by the remuneration policy and design have been achieved.

This portion needs to be an attractive portion of the overall remuneration mix if it is to be effectively wielded as a tool that motivates executives to focus on the long-term goals of the company (and via the payout their own goals).

What should be considered when setting executive pay?

This article, so far, has focused on the executive and how the pay mix is meant to influence them, however, broader stakeholders such as other employees and society must be taken into account when setting the remuneration policy and design. Attracting the right caliber of executive is important but not at the expense of alienating the rest of the staff and society at large, particularly in a country like South Africa which has one of the most unequal distributions of income in the world. Too often, remuneration is set with 'pleasing the shareholders' rather than 'pleasing the stakeholders' in mind.

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A common explanation offered when share schemes explode as a result of rampant share prices is that the executive is benefiting from the company's success, but can that success be attributed to the executive? A good example is the current high gold and oil prices that will lead to increased revenue in these industries if the same level of product is sold. These global conditions have nothing to do with any executive, but they will benefit from this. The converse is also true eg. when markets crashed at the start of the global Covid pandemic.

"Perhaps the answer is the implementation of a maximum price that any share issued under an executive share scheme can reach? Eg. If executive X receives shares at a price of R1 per share, perhaps a cap of R3 per share could be put in place at the point of sale so that even if the share price reaches R10, these shares are still only redeemable at R3 (this would require a company buy back or similar rather than the open market but the mechanics of such a transaction are beyond the scope of this article).

The way forward

It is of vital importance that the most influential roles in organisations are held by capable, skilled and responsible people. For this reason, attraction and retention play a significant role in ensuring that the business is able to operate optimally. However, alienating the staff to attract and retain an individual is not a sustainable solution as this can lead to reduced performance at staff level due to perceived unfairness and this can spill over into the public domain.

Executive packages should be set up in such a way that they are externally attractive to bring the skills in, achievable to motivate the executive to achieve the organisational goals, and fair and responsible so that the remuneration package does not alienate the staff and the broader stakeholders such as the public. These are the principles promoted by King IV but public opinion is that some organisations have got a long way to go in achieving them.

ABOUT CHRIS BLAIR

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