

## Point of View

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# Market Responsive, Yet Socially Responsible Executive Pay

Flowing from the global financial crisis and an expected slow recovery, executive remuneration has increasingly come under the microscope. Shareholder concerns, media exposure, a populist view of excessive pay and increasing government intervention are all indicators that some change is needed in executive remuneration.

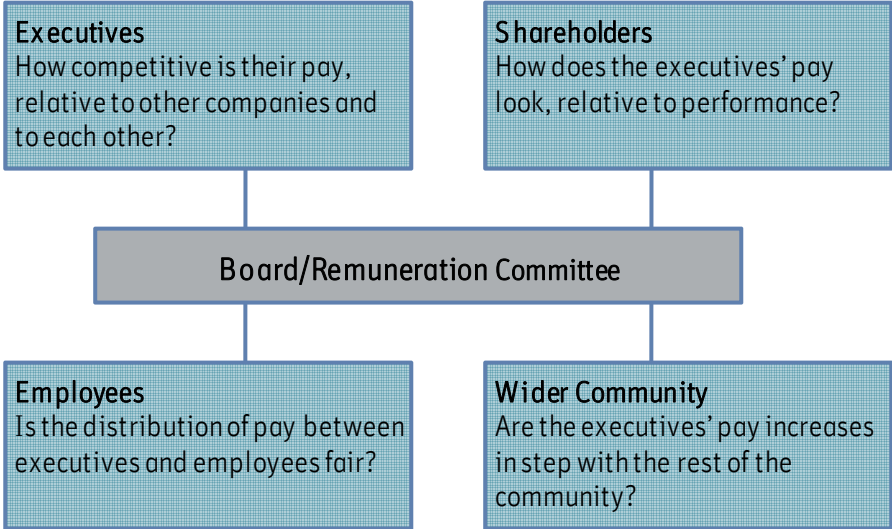
Many company directors have reacted to calls for increased regulation by asserting that Australia has one of the best remuneration governance regimes in the world and that increased intervention, because of a few 'bad eggs', is unnecessary. In a sense we do have one of the most advanced governance and disclosure frameworks in the world, yet many interested parties believe there is still considerable room for improvement. Organisations representing shareholder interests, such as the Australian Shareholders Association, RiskMetrics, Regnan and others, have all issued updated, more detailed guidelines on executive pay this year – some more prescriptive than others.

The Productivity Commission's current review of executive remuneration includes, in its terms of reference (TOR4): 'Consider any mechanisms

that would better align the interests of boards and executives with those of shareholders and the wider community'. At Hewitt CSi, our view is that companies need not wait to see whether this leads to specific Government-regulated mechanisms. There are unregulated, pro-active approaches companies can adopt, to be more responsive to shareholder, employee and wider community interests, while ensuring their executive remuneration is competitive enough to attract, motivate and retain the right senior talent.

**What are the Key Questions to Ask?**

The following diagram provides a high-level depiction of how the board or remuneration committee can take a socially-responsible approach to the range of stakeholder perspectives on executive remuneration.



Drilling down a little further into these questions gives rise to the idea of a benchmarking scorecard along the following lines.

Executive Remuneration Benchmarking Scorecard	
Executives	<ul style="list-style-type: none"> <li>▪ How does our remuneration intent compare with the remuneration intent of others:               <ul style="list-style-type: none"> <li>– For each executive position?</li> <li>– For the executive team as a whole?</li> <li>– In terms of selected remuneration ratios among executive team members?</li> </ul> </li> </ul>
Shareholders	<ul style="list-style-type: none"> <li>▪ How does our actual remuneration compare with actual remuneration of others, taking company size and performance into account?</li> <li>▪ How does our actual remuneration increase compare with our own performance improvement, relative to others?</li> </ul>
Employees	<ul style="list-style-type: none"> <li>▪ How does our remuneration increase for the executive team compare with our remuneration increase for other employees?</li> </ul>
Wider Community	<ul style="list-style-type: none"> <li>▪ How does our remuneration increase for the executive team compare with the overall remuneration increase for the Australian workforce?</li> </ul>

**Analysis - Executives**

The first step is to review how the company’s relative market positioning on target remuneration compares with its relative size positioning within the comparator group selected.

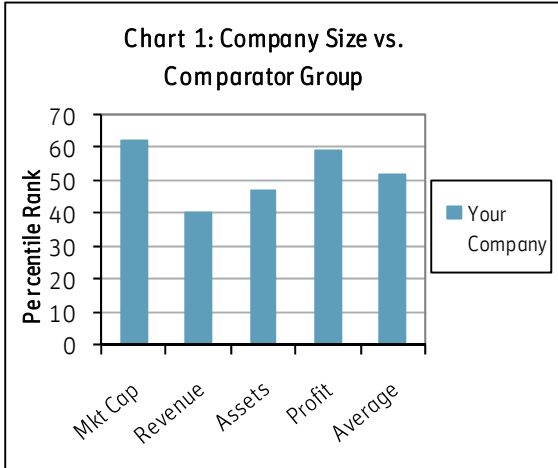


Chart 1 shows a sample company’s percentile rank within a selected comparator group on a range of common company size measures (market capitalisation, revenue, assets and profit), as well as the average of these ranks (overall measure of size).

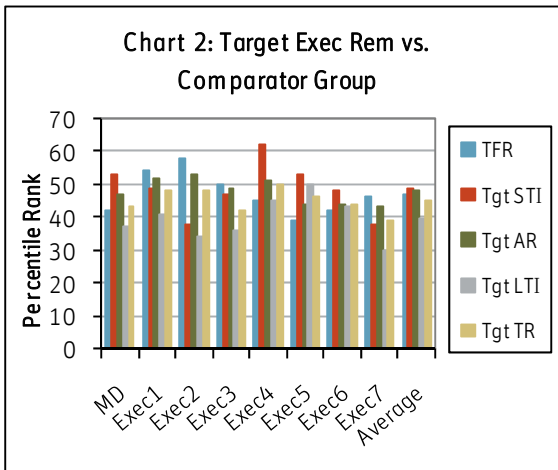


Chart 2 shows the percentile rank for each of the company’s executives (Managing Director and seven other executives), on each component of remuneration:

- Total Fixed Remuneration (TFR)
- Target Short-Term Incentive (Tgt STI)
- Target Annual Remuneration (Tgt AR): the sum of TFR and Tgt STI
- Target Long-Term Incentive (Tgt LTI)
- Target Total Remuneration (Tgt TR): the sum of Tgt AR and Tgt LTI).

Chart 2 also shows the average remuneration percentile ranks across the executive team. The overall rank for Tgt TR is 45th percentile, while in Chart 1 the average size rank for the company is the 52nd percentile. This suggests that the company’s target remuneration positioning may be a little ‘under-weight’ relative to its size.

Many companies would undertake no further analysis and apply the above results to executive remuneration increases, such that the size of the increases would bring the market positioning of its executive team somewhat closer to the company’s size rank, or at least to the market median. However, before arriving at such a decision we will examine other elements of the benchmarking scorecard.

The next aspect of the analysis addresses internal relativities among the executive team, with Tgt TR ratios between:

- The MD and average of next five highest-paid executives
- The highest-paid of the next five executives and the average for those five
- The lowest-paid of the next five executives and the average for those five.

The results for our sample company are set out in Table 1.

**Table 1: Selected Target Total Remuneration Relativity Ratios**

Statistic	MD vs. Avg Top 5 Execs	Highest Top 5 vs. Avg Top 5 Execs	Lowest Top 5 vs. Avg Top 5 Execs
25 <sup>th</sup> percentile	1.87	1.20	0.65
50 <sup>th</sup> percentile	2.32	1.41	0.75
75 <sup>th</sup> percentile	3.02	1.68	0.86
Average	2.53	1.45	0.75
<i>Your Company</i>	<i>2.19</i>	<i>1.46</i>	<i>0.73</i>

In this case the MD's Tgt TR is a relatively modest multiple of the next five average (2.2 times, which is below the comparator group median).

In other cases, especially where this ratio is extremely high, credit rating agencies such as Moodys may raise a 'red flag', perhaps suggesting concern that the company is overly dependent on one executive (a very highly-paid MD), with poor succession planning reflected in the much lower pay at the next tier.

### Analysis - Shareholders

To complement the remuneration intent analysis above – based on target remuneration values – we now review how the company's actual remuneration payments for the most recent year compare with its relative size and performance.

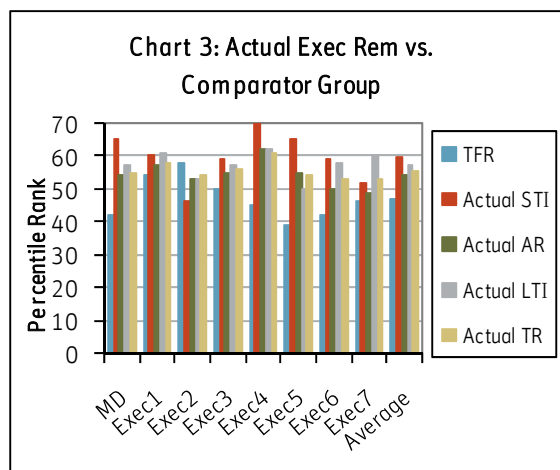
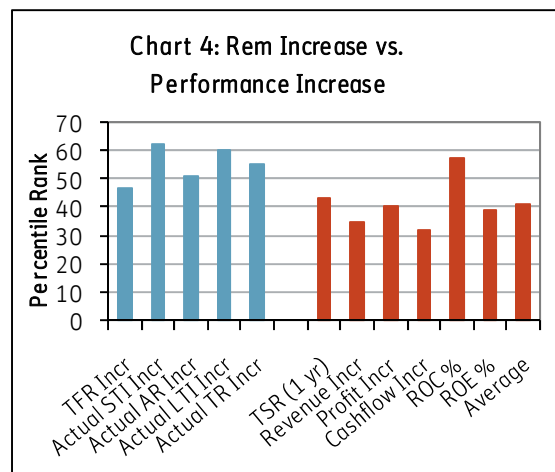


Chart 3 shows the executive team's actual remuneration for the past year. Their average Actual TR is at the 56th percentile, which is a little higher than the company's relative size (52nd percentile), as per Chart 1.



In Chart 4 we present the percentile ranks for the company's actual remuneration increases (last year over the previous year) for the executive team as a whole. We also present the company's percentile ranks for a range of performance measures (1-year total shareholder return, revenue increase, profit increase, cash flow increase, return on capital, return on equity) and the average of these performance ranks.

While the company's Actual TR increase is at the 56th percentile, its overall performance rank is considerably lower, at the 41st percentile.

Considering Charts 3 and 4 together, it appears that the company's actual remuneration is a little 'over weight' for its performance.

**Analysis – Employees and Wider Community**

The final element of the benchmarking scorecard covers company employees and the wider community (Australian workforce).

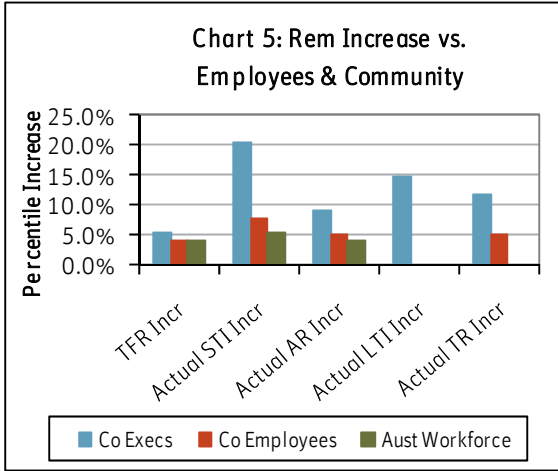


Chart 5 shows that the sample company’s executive remuneration increases were significantly higher than for the other two groups.

**Summary**

The worked examples in this paper indicate that different stakeholder perspectives of a company’s executive remuneration positioning may give different impressions of whether the company’s remuneration levels appear reasonable.

In this case the initial market benchmarking, based on target remuneration, suggested that the company’s pay positioning was a little low relative to other companies of comparable size. However, analysis of actual executive payments, relative to performance, suggested a different view. Considering these two pieces of evidence together, there may be a need to check the sample company’s approach to performance target setting and the degree of difficulty associated with incentive pay-outs at various performance levels, before approving executive remuneration increases.

More explicit reference to percentage remuneration increases for the company’s other employees and the Australian workforce generally may also guide the remuneration committee’s assessment as to whether proposed executive remuneration increases appear reasonable in all the circumstances.

In the end, executive pay needs to be market responsive, in order for the company to compete successfully. However, traditional executive benchmark analysis should not be the only input into this process – the perspectives of other key stakeholders may also be taken into account and given appropriate weighting.

For further information on Hewitt CSi executive remuneration benchmarking approaches, contact Peter Ryan in Sydney on: +61 (0) 2 9101 9050.

**About Hewitt Associates**

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