Guide to setting executive pay

By Mark Bussin

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Executive pay is a trigger for many media commentators and shareholder activists, but the truth is that remuneration committees (Remcos) have developed several methodologies for tackling what is a very challenging issue. Three main methodologies are used in South Africa where, in general, remuneration governance is on a par with global standards thanks to widespread adoption of the King Codes of Corporate Governance issued by the Institute of Directors in Southern Africa.

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Each method has its own strengths and weaknesses, and reward professionals need to understand them thoroughly in order to make the right choices - particularly as the practice of naming the consultant used by the Remco is gaining traction. It is also worth emphasising that these methodologies are not watertight categories, and reward professionals will typically use elements of more than one methodology to arrive at a recommendation.

Market benchmarking

This is by far the most commonly used methodology in South Africa, and has the benefit of being easy to understand and of making intuitive sense. As the name implies, its basic principle is to establish what the CEOs of companies of similar size and complexity are being paid, and to use that figure as the basis for negotiation.

In this case, size is important because the job description of the CEO of an international bank will look very similar to that of the CEO of a four-store chain of hardware shops; the difficulty and impact of the respective jobs is clearly related to the relative size and influence of the two companies.

Various metrics are used to establish company size, but the most common, and most reliable, are turnover or revenue; nett profit before tax; number of employees and annual salary bill.

Other criteria are market capitalisation, geographic footprint and assets. Depending on the particular circumstances, there might be a case for including these last mentioned criteria, but with care. For example, the relative size of asset bases can give a very misleading picture of the difficulty of the CEO’s job. Thus, a company that owns a large amount of fixed infrastructure, such as a road or rail network, might be as large or larger than a multinational financial services company in terms of asset base — but running the latter is a much tougher job than the former, and the potential for loss is much higher.

This last point leads onto what is the major drawback of this methodology: it is something of a blunt instrument. Company size says a lot about the complexity and difficulty of the CEO's job, but not everything. It should thus not be used uncritically.

Competitor model

This model also uses peer companies as the basis for setting the parameters of the discussion, and thus the first step has to be identifying suitable companies. The benchmarking methodology described above will obviously be helpful in this regard.

Having determined the right companies for comparison, this methodology compares the relative performance of the companies. Thus, a company that performs in the top quartile as compared with its competitors will pay its executives more than those of a similar company in a lower quartile of performers.

Obviously, company performance varies dramatically, so this methodology is perhaps most useful when used to determine the performance-related (variable) portion of the executive's compensation package. Following a mixed model, then, benchmarking might be used to set the executive's basic salary, while the competitor model forms the basis for establishing his or her incentives and share options.

Job-sizing

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This methodology is much more complex than the preceding two, and attempts to enable the reward professional to categorise the executive's job more finely, and correlate it more closely to the rest of the market, using salary survey data. Many consultants have developed their own versions of this approach — this description will thus be as general as possible in order to identify the principles.

Based on research and experience, the methodology establishes the key criteria for evaluating executive positions. My own methodology, Execu-Measure, uses company size, the strategic level of the job, its impact, and its complexity and/or requirement for problem-solving.

The process begins with establishing the magnitude of the job using company size. The criteria would typically correspond to the four listed in the benchmarking model above; the Execu-Measure methodology uses one of the following: number of employees, total assets or total equity/liabilities.

The company sizing is the most heavily weighted factor. Once it is established, it is refined using a granular evaluation of the job itself. Execu-Measure uses three main categories, each with several sub-categories:

- Impact of the job (direct, joint or indirect);
- Strategic level, or freedom to act. This looks at whether the job is strategic across the whole group or at business-unit/company level, as well as execution responsibilities; and
- Freedom to think in the context of freedom to act. Here, the various categories are a freedom that is abstractly defined, broadly defined or well-defined.

All of these factors are weighted and values put into a large matrix, so that a particular job's metrics can be cross-referenced to a single job level. The job levels correlate to those used in the various salary surveys.

Thinking carefully through the methodology that is used is critical because the remuneration policy and implementation need to be defensible. It should further be noted that because there are so many factors involved, as well as the need to exercise judgement, that no formula can simply be applied. At the same time, Remcos and reward professionals should be aware that the executives will, of course, be advocating metrics and criteria that would favour higher rewards for themselves. Remuneration policies and strategies need to be robust.

The following guiding principles should inform the remuneration strategy and its implementation:

- Tie pay as directly as possible to performance and value delivered to the company;
- Use market norms as much as possible, they are a valuable benchmark. However, as noted above, it is necessary to think deeply about what market norms to use in the context of the company's business; and
- Impeccable governance is absolutely essential.

It is always going to be difficult to get remuneration right, and it is unlikely that everybody will be satisfied. But with the right degree of care and thought, the reward professional can craft something that is fair, that can be defended and that, most important of all, supports the company's strategic goals.

ABOUT MARK BUSSIN

Dr Mark Bussin is the chairperson of 21st Century Pay Solutions and an Exco member of the South African Reward Association (SARA).

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