Is it time to move the carrot?

Systems involving executive rewards and short-term goals need to be overhauled for a sustainable future, writes Mary O'Hara of PwC

THE ONGOING debate around bonuses and risk-taking has placed executive reward at the forefront of the corporate agenda. Various interested parties, including shareholders, institutional investors, regulators, industry bodies, media commentators, and even management teams say executive compensation systems are in need of significant reform.

Regulatory bodies worldwide are taking the opportunity to reassess both their own good practice guidelines and the role of the investor in challenging boards about remuneration policies. Current practices, it is observed, are not only too short-term oriented, but also have largely failed to meet either of their key objectives: motivating executives and aligning their reward with shareholder outcomes.

Clearly, action needs to be taken to transform the governance and design of executive pay. However, making fundamental changes will be difficult, since in many cases the level of trust between companies and their shareholders in the area of remuneration is now low.

Bringing about change will require an improvement in this trust. As a first step, improved consultation with shareholders should aim to create greater support for the judgment of remuneration committees and more trust in executives to act responsibly.

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❐ What might the new landscape look like?

There is a widely held perception that the short-termism inherent in incentive plans contributed substantially to the current crisis. In particular, there is concern that risk and compensation are not always closely aligned. For example, an executive might be able to take a bonus based on a mark-to-market profit in one year, that becomes a loss in subsequent years.

Organisations need to ensure remuneration models are tailored to business strategies, moving away from a follow-my-leader mentality. Simplification will be critical to success, with fewer complex incentives and a greater focus on long-term arrangements to achieve alignment.

There is a realisation that bonuses should be driven, not by an annual measure of performance, but on performance measured over a period that is closer to, if not beyond, the life of the activity in question. Incentives should not require or encourage executives to execute a quick "flip" when the potential for the most value creation is over the longer term.

❐ Need for clarity and transparency

There is an obvious need for clarity and transparency around the area of "pay for performance", with a focus on rewarding outputs, not effort. This requires a clear articulation of what constitutes performance, with skill and luck separately identifiable.

Already there are signs that organisations are taking steps to replace short-incentive payouts with long-term programmes featuring higher degrees of equity or deferral.

Many are also considering making the eventual receipt of deferred bonuses subject to longer term performance: so-called clawback.

❐ Enhanced employee engagement

Recent studies suggest that there should be a better balance between the financial management and motivational aspects of reward than was evident in the past.

The non-cash rewards (benefits and pensions and so on) as well as intangible rewards (career development opportunities, improving work climate and so on)