Supporting the transition to post-pandemic sustainability

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Executive remuneration packages not only drive a race to the top but do not account for companies' environmental 'externalities'. This needs to change.


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In wistful conversations about 'life after Covid-19', two seemingly unrelated issues to be addressed appear: the pay and precarity of essential workers (in retail and social care, for example) and longer-running anxieties about climate change.

The pandemic has highlighted the low pay and insecure employment which blight the lives of many frontline employees—as wholly at odds with the value society now places upon such workers. Less attention has however been paid to the other end of the incomes spectrum, specifically to the senior executives and directors of private-sector companies.

Executive remuneration packages have escaped the constraints which normally govern wage growth for some time. This has prompted a chorus of criticism, including from the Trades Union Congress and the High Pay Centre in the United Kingdom and Eumedion in the Netherlands.

Yet, beyond ensuring that base salaries, benefits, annual bonuses and long-term incentives are more transparent in annual reporting, corporate governance at national level has stopped well short of imposing any caps on executive remuneration. Neither have there been any serious attempts to make the connection to climate change.

Spiralling upwards

On top of big basic salaries, generous pensions and attractive fringe benefits, additional short-term bonuses and long-term share options—linked to key financial-performance indicators—have sent top pay spiralling upwards. Generosity with shares and share options, it has been assumed, binds the personal fortunes of the highest-paid executives into the company's financial performance, militating against risky behaviour in favour of decisions that boost the share price.

The 2008 financial crisis and subsequent corporate failures have however put the wisdom of this assumption in question. One economist has noted 'many examples of boards opting for instant gratification through ill-judged acquisitions that boost share prices in the short term rather than for careful targeted longer-term investment and expansion of productive capacity'.

Such criticism has prompted moves to encourage other criteria for executive remuneration. For example, the UK's Financial Reporting Council recognises longer-term, non-financial indicators 'as a valuable measurement to achieve long-term success'.

Having assessed 82 annual reports from FTSE-100 companies, the FRC noted: ‘There is some movement towards the use of additional non-financial metrics, such as diversity, culture and health and safety targets.’ But it concluded: ‘All sampled companies used financial KPIs [key performance indicators] to measure their annual bonus and LTIP [long-term incentive plan] awards.’

Our own research confirms this heavy reliance on financial KPIs. In the UK, we reviewed Astra Zeneca, Vodaphone, British American Tobacco, Barclays Bank and Diageo and, in the Netherlands, Phillips, Unilever and Royal Dutch Shell. Despite rhetoric about corporate responsibility and concern for the environment expressed in annual reports, board-level and senior executive remuneration remains inextricably linked to short-term financial metrics, with little or no connection to wider environmental needs.

Environmental performance

One way of addressing this—and the huge differences between top and-average pay in a typical company—would be to replace financial incentives with environmental-performance indicators. The annual reports of the companies we examined all celebrated their environmental performance and lauded the targets they had set for the coming years.

Take, for instance, Astra Zeneca’s recently announced strategy ‘to achieve zero carbon emissions from our global operations by 2025 and ensure our entire value chain is carbon negative by 2030’. It does not take much ingenuity to imagine how executive pay at this company could be incentivised using a mix of short- and long-term environmental-performance indicators (EPIs)—combining, for instance, planned reductions in annual carbon-dioxide emissions in global operations and value chains with targeted increases in energy efficiency. Many other EPIs could be devised to fit the specifics of the business, but all would provide an environmentally relevant set of criteria to guide variable payments to top executives.

What we propose is not revolutionary. Board-level and senior executive remuneration would still be incentivised but the link with short-term financial targets would be broken. Three further changes are however needed.

‘Talent market’

First, shares and share options should be taken out of the process, leaving incentive payments only in cash. Decisions aimed at boosting share prices in the short run have rarely been good for the company, still less for the climate.

Secondly, remuneration committees typically benchmark packages for chief executives and other senior managers against peers on the ‘global executive talent market’. Such comparisons establish ‘rents’ for top positions, which are wholly removed from the value the individual brings to the particular business and from its pay structure. In the companies we reviewed, in 2019 the ratio of chief-executive to average/median pay varied from about 70:1 for Philips and Unilever up to 208:1 for Diageo. Can there be any justification for differentials of this size?

Thirdly, and relatedly, remuneration committees themselves need to be reformed. To be truly objective, their members should be appointed independently of the chief executive. We think it would be better to reconstitute them as formal stakeholder advisory panels, with equal numbers of employee and shareholder representatives.

As such, they would be charged with linking executive remuneration to more tangible indicators than ripples in the talent pool—and, most importantly, ensuring company incentive programmes are focused wholly on accelerating the transition to post-pandemic, and long-term, sustainability.

About Denis Gregory and Maarten van Klaveren

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