1.6. THE HOLISTIC FRAMEWORK FOR THE ECONOMICALLY AND SOCIALLY FAIR CEO COMPENSATION

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Abstract

This paper aims to conceptually discuss how to reach the *economically and socially* fair and optimal CEO compensation based on equity principle, behavioral agency, and stakeholder theories and to suggest future research avenues for scholars. It contributes to practice and academy by providing the guidelines for socially and economically fair and optimal CEO pay, which is still a highly controversial issue. It also contributes to the literature by informing the researchers of the overlooked themes.

1. INTRODUCTION

This paper has three main objectives. First, it aims to reveal the traditional framework of the corporate governance and executive compensation, developed based on shareholder approach, and then to conceptually discuss how to reach the *economically and socially* fair and optimal CEO compensation according to equity principle, behavioral agency and stakeholder theories. It also emphasizes that the holistic executive compensation structure should be supported by the new corporate governance (KISS) system. Finally, it concludes with the proposal of a future research agenda for the understudied and overlooked themes regarding executive compensation. This paper is structured as follows: First, the conceptual and theoretical frameworks and challenges are explained by referring to social and economic fairness. Then, the future research avenues of executive compensation are summarized to guide the scholars on the implementation of these suggested structures into the qualitative and quantitative research and the emerging themes in this area.

2. BACKGROUND

In this section, first, the traditional corporate governance and executive compensation structures are illustrated, and then the alternative approach of holistic and fair CEO compensation framework is introduced, which requires a new KISS approach of the corporate governance structure. Unfortunately, the corporate failures and public distress over the lucrative compensation have revealed that fairness has not taken into consideration when executive compensation schemes are designed (Chaigneau, 2018; Ferracone, 2010). Fairness is a social and ethical norm and it deals with 'what is just' and 'what should be done' (Pepper, Gosling, & Gore, 2015). It includes two approaches: the *equality (egalitarian) approach* and the *equity approach*. The *equality principle*, such as Scandinavian countries applying, states that "all people should be treated the same way regardless of their performance". On the other hand, the *equity principle* is satisfied "if those who perform better than others are entitled to higher compensation" (Rost & Weibel, 2013, p. 353). Thus, the fair and optimal CEO compensation framework in this paper, derived from the equity principle, not equality, answers the question of 'which factors should be taken into consideration to have an economically and socially just compensation scheme'.

2.1. The existing framework

Corporate governance is a system that governs, directs, and controls the firm at the top (Hilb, 2016; Wixley & Everingham, 2002). In general, in the literature, two types of corporate governance systems have been mentioned: the shareholder (market-based competition) approach and the stakeholder (relationship-based cooperation) approach (Hilb, 2016). In this commentary paper, the third model, new corporate governance (KISS) approach, is explained since it goes hand in hand with the holistic and economically and socially fair compensation system. If the governance system of the organization is a shareholder based traditional model, then the fair and holistic compensation framework may not be implemented successfully. Thus, first, the traditional corporate governance model and the new corporate governance model are summarized in Table 1 and Table 2, respectively. Then, the compensation frameworks are analyzed. Table 1 illustrates the traditional corporate governance system which is not situational, strategic, integrated, and holistic. The traditional approach, depending on the shareholder theory, focuses on and controls only the financial dimension to maximize the shareholder value. The board of directors

(BoDs) does not involve strategic development, it is mainly handled by the executive board. Nomination and remuneration committees are isolated from each other, and governance structure does not consider the differences in corporate culture, industries, and nations. In simpler terms, the system is very standard, with no diversification or differentiation, and it is mainly financially driven and managed (Hilb, 2016).

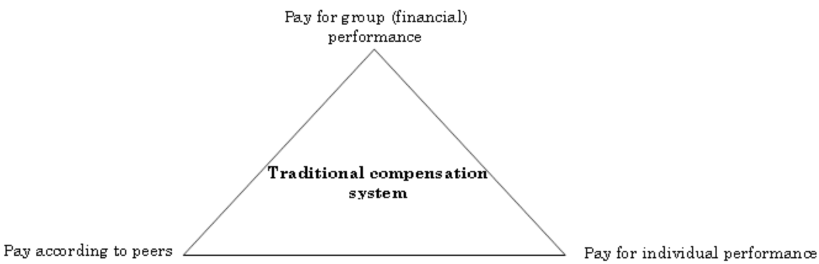
Table 1. Traditional corporate governance

Dimensions	***Traditional corporate governance***
Situational implementation	No difference between national, industry, and corporate culture
Strategic direction	Strategic development is not a function of the supervisory board
Integrated board management	Only isolated nomination and remuneration committees in publicly listed companies
Holistic monitoring & holistic structure	Controlling the financial dimension only

Source: Hilb (2016, p. 8).

In the traditional compensation framework, which is generally accompanied by traditional corporate governance structure in practice, there are three main evaluation criteria: pay for financial performance, pay according to peers (benchmarks), and pay for individual performance (Figure 1). In this model, the CEOs' compensation schemes are designed based on some key financial indicators, such as total shareholder return (TSR), earning per share (EPS), net operating income (EBIT), etc. (Ferracone, 2010), benchmarking or relative performance evaluation (RPE), and the individual performance, such as leadership skills, intrinsic motivation, behavior, etc. (Bushman, Indjejikian, & Smith, 1996; Lobo, Neel, & Rhodes, 2018).

Figure 1. Traditional compensation framework



Source: Prepared by the author.

On the other hand, to have a holistic and economically and socially fair executive compensation framework, the organizations should improve their corporate governance system and executive compensation scheme, which are integrated and which support each other. This is discussed in detail in the following section.

2.2. The holistic and fair framework

Compared to traditional corporate governance structure, disclosed in Table 1, the new corporate governance model is discussed below. Table 2 depicts the new corporate governance (KISS) model which is situational, strategic, integrated, and holistic. It is developed based on the stakeholder approach and agency theory, but it values each party in the stakeholder's group equally. Thus, it differentiates a bit from a stakeholder approach. The stakeholder approach weighs the society, environment, and the public strongly than shareholders. In the reversed KISS approach, all the parties are equally important. KISS stands for Keep it (S)ituational, (S)trategic, (I)ntegrated and (K)eep it controlled (Hilb, 2016).

A new corporate governance system controls both the financial and non-financial dimensions to maximize the stakeholder value (keep it controlled and holistic). The board of directors does involve strategic development. In essence, it is the central function of the board of directors (keep it strategic). Nomination and remuneration committees are integrated. In simpler terms, the selection, recruitment, appraisal, and compensation processes of the executives and BoDs are considered all together, so they are paid for competence, characteristics, and individual performance as well as corporate and group performance (keep it integrated). Governance structure does consider the differences, so each firm has its own specific corporate governance context based on its corporate culture, industry, and nation (keep it situational) (Hilb, 2016). In short, the system is with diversification or differentiation, and it considers the wellbeing of investors, customers, employees, suppliers, government, political groups, trade associations, society, environment equally, and as a whole.

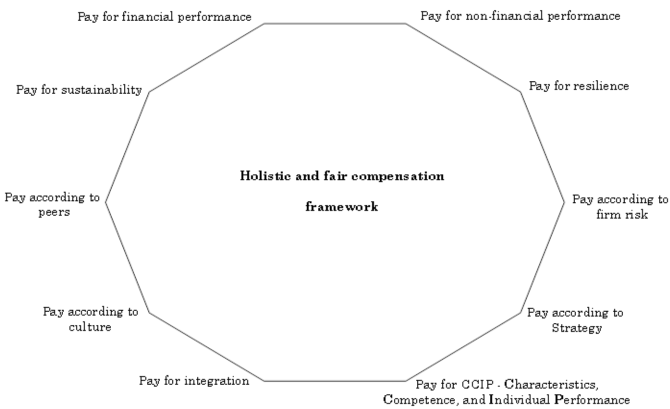
Table 2. New corporate governance (reversed KISS approach)

Dimensions	*New corporate governance*
Situational implementation	Implementation appropriate to the specific context of each firm (Keep situational)
Strategic direction	Strategic development is a central function of the supervisory board (Keep it strategic)
Integrated board management	Integrated and targeted selection, appraisal, compensation, compensation, and development of the supervisory and managing boards (keep it integrated)
Holistic monitoring & holistic structure	Holistic monitoring of results from the perspective of shareholders, clients, employees, and the public (keep it controlled)

Source: Hilb (2016, p. 8).

In the holistic and fair executive compensation framework, which is suggested to be implemented with the new corporate governance (KISS) structure, there are 10 components (Figure 2): pay for financial performance, pay for non-financial performance, pay for sustainability, pay for resilience, pay according to peers, pay according to firm risk, pay according to culture, pay according to strategy, and pay for integration, and pay for characteristics, competence, and individual performance. All of these 10 factors have to be considered and satisfied to have the desired effect (Eklund, 2019). In this model, which is developed in line with the tenets of the stakeholder and behavioral agency theories, all parts of the stakeholders have been equally valued. In addition to the three common factors (*pay for financial performance*, *pay for individual performance*, and *pay according to peers*) which were also illustrated on Figure 1 and discussed above, the holistic framework in Figure 2 includes *pay for non-financial performance* and *pay for sustainability*, such as customer, suppliers, and employee satisfaction, environmental, social, and governance performance, etc., *pay for resilience*, which is the key factor during the crises, such as social and financial indicators measuring the CEO's performance to protect the health of the employees and to make a resilient organization at the same time during Covid-19 crisis. *Pay according to a strategy* indicates that the CEO compensation and its structure should be in line with the long-term goals and strategy of the organization, and CEO should be rewarded if the strategy and long-term goals are accomplished. *Pay according to culture* means that CEO remuneration should be pertinent to corporate and national culture. *Pay according to risk* presents that the variable pay of a CEO should depend on the systematic and unsystematic firm risk. *Pay according to integration* is related to concepts of the pay gap within the management level, internal fairness, and equity in the pay levels in the organization (Eklund, 2019).

Figure 2. Fair and holistic compensation framework



Source: Prepared by the author by deriving from Eklund (2019, p. 11).

2.3. Meeting the challenge

Although the suggested frameworks in this paper are scientifically driven, holistic, and fair, none of the models are without limitations. The frameworks may reveal a statement of executive compensation and corporate governance that may seem obvious and simple, but this is not the case. Moreover, these approaches do not mean that they propose a "one-size-fits-all" approach, which would be very risky and harmful. They are only the tools to discover the organization's own best, fair, and optimal structure. Despite the limitations and caveats, both frameworks meet the criteria for a good model, proposed by Brown (1965), — they are simple, clear, logical, and applicable to real-life situations (Eklund, 2019; Hilb, 2016; Melis, 2011).

3. FUTURE RESEARCH

This conceptual and holistic executive compensation framework opens future research avenues to the scholars because they can apply and test this scientifically driven framework in their empirical and qualitative studies. Moreover, it is evident that abundant attention has been given to the financial aspects of executive compensation, but there is still scarce research on the ethical, social, and environmental aspects.

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CONFERENCE FORUM DISCUSSION

Mehtap Eklund: Welcome to my presentation. The purpose of this presentation and the working paper is to conceptually discuss how to reach the economically and socially fair and optimal CEO compensation from the perspective of behavioral agency and stakeholder theories and equity approach. The further aim is to empirically test this framework. If you have comments or feedback on this concept, feel free to drop your comments here. Your valuable comment and feedback are highly appreciated.

Alex Kostyuk: I fixed a set of interesting ideas coming from your paper. First, I feel that the optimization of the links you mentioned in your paper we need to refer to the national business rules and cultural stereotypes (globalization is still weak in this case). Second, it was mentioned in the paper that "Stakeholder theory postulates that firms must demonstrate the commitment to socially responsible behavior to achieve legitimacy". Probably, there is a difference between companies with strict regulation (such as banking) and less regulated. Do not you think that in the strictly regulated industries social responsibility is substituted by meeting the requests of strict regulation? Do not you think that because of the above-mentioned role of regulation makes the banks as less responsible during a crisis and the bank CEO compensation during a crisis is outside of any social responsible context (for example, when non-profitable banks pay higher compensations to their CEOs as it was in 2008?)?

Vikash Ramiah: What I have observed is to be socially responsible costs money. Organizations that are govt owned or semi govt own tend to engage more responsible. Also, it is time to expand CSR to SDGs.

Alex Kostyuk: Vikash, that is true about SOE and CSR investments from the point of view of the concept. In practice, the costs of this concept can be extremely higher because the corruption is very popular exactly in SOE in many countries and as a result, the costs of control over the SOEs grow remarkably making CSR investments not effective.

Vikash Ramiah: Some organizations are capitalizing on this now. They call it branding and marketing it. There is a market for it. For instance, organic products cost more but there are clients buying just organic stuff. You can see a small car cleaning business using the logo "green" or "enviro-friendly".

Mehtap Eklund: Thanks, Alex and Vikash, for your valuable inputs. I will definitely control the ownership (governmental and non-governmental) effect into consideration when I will empirically test it in the Swiss market. Thanks for the valuable comment. It is very interesting to hear that banks may not be as much as socially driven compared to other sectors. Maybe, they are not environmentally malignant as much as other sectors, like mining, oil, manufacturing, etc.

Mehtap Eklund: Do you suggest any other factors that we need to consider in the holistic CEO compensation framework? Any factor that I missed? Any comment is highly appreciated.

Vikash Ramiah: Banks finance the polluting sectors, Mehtap. They become partners in crime and they don't want to be perceived as the bad guys. Some banks refuse to handle certain polluters (for example, coal electricity producers). In fact, the costs of debt for polluters are higher. Green bonds tend to be cheaper as it does not have environmental risk. Banks are offering cheaper debt if you are environmentally responsible as they have enjoyed a cheaper rate too. I get questions a lot on why are lenders asking about my emissions? Well, even if they do not report publicly, some banks request this information to give cheaper rates. Banks are building their portfolio to show social investments as the world is watching.

Mehtap Eklund: It is very promising to hear that environmental risk is considered in addition to the systematic and unsystematic risk of the firm by the banks. Then, I wonder how the banks reflect this to their own CEO compensation schemes? Through the ESG performance of the bank? What do you think?

Vikash Ramiah: I have not done any work around that and you raise a good question. The only thing that comes to mind now is the style of leadership. I think the leader of AESOP is quite vocal about SDGs and shows how her company is addressing these goals. She sells more and at a higher price too. I guess high sales means high profit. But she is known to be an advocate in this field. I guess if the companies profit increases, they can cash in their options, bonuses, etc. It will be a good area to study.

Mehtap Eklund: Thanks for the valuable input.

Maha Radwan: Very interesting discussion and I agree with Vikash regarding banks' need to show that they are socially responsible for impact investments; however, Mehtap raised a good point of that this would affect the CEO compensation, could you please shed the light on the results of the research?

Mehtap Eklund: What do you mean? It is a working paper and the preliminary results are available. The robustness checks are needed to be done.

Omrane Guedhami: Hi Mehtap. This is a very interesting paper. I have two comments. State vs. private ownership can matter. However, I am not sure to what extent state ownership is important in Switzerland. If you are interested in the theory underlying the role of the state, please see *Boubakri, N., Guedhami, O., Kwok, C. C., & Wang, H. H. (2019). Is privatization a socially responsible reform? Journal of Corporate Finance, 56, 129-151.* You can consider controlling for family control and especially the role of institutional owners (*Dyck, A., Lins, K. V., Roth, L., & Wagner, H. F. (2019). Do institutional investors drive corporate social responsibility? International evidence. Journal of Financial Economics, 131(3), 693-714*). Finally, can you consider examining the consequences of compensation in terms of performance or cost of capital?

Alex Kostyuk: Hi Omrane, welcome to our online forum. I see your comment and entirely share your point of view. My vision is about the national specifics of state ownership and its regulation. Moreover, the process of privatization adds even more national specifics to this issue. When more than two decades before in Ukraine we experienced privatization, we introduced a German model of CG, based on a two-tier model of the board of directors, but....we forgot to provide the employees with a right to delegate their representatives to the supervisory board, and since that time any social effect of privatization in Ukraine was over. That was a paradox, but this is the case.

Omrane Guedhami: Hi Alex. Thanks for these insightful comments. I agree with you. In fact, we discuss/document differences of state ownership across a different institutional environment.

Alex Kostyuk: I absolutely agree, Omrane. Finally, corporate governance in SOEs seems to be a very specific science. Yes, it is still called "corporate governance", but this still requires more fundamental research and empirical papers considering a large variety of countries.

Mehtap Eklund: Thanks, Omrane and Alex, for the valuable feedback. I am sorry for the delay in the reply due to time difference (-7 h) and I had to teach during the day. I will definitely control ownership and state effect and board structure as a control variable in my empirical data. Thanks for sharing valuable ideas and journal articles. Appreciated.