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Executive remuneration schemes and their alignment with business sustainability

Executive pay is under intense scrutiny internationally by governments, the media and social commentators. This paper offers principles that should underpin remuneration schemes, reassuring stakeholders that performance-related pay reinforces behaviours that create long-term sustainability.

Discussion paper May 2010

Conclusions

1. Executive incentive schemes that encouraged excessive risk taking are part of a wider problem that contributed to the global economic crisis in 2008.

2. Imbalanced remuneration systems can hurt a company's long-term strategy by encouraging a focus on short-term gains.

3. A widening gap between executive pay and average wages has triggered understandable public concerns about fairness.

4. Well publicised excesses in the financial sector are leading to reforms pushed by governments and other stakeholders.

5. Bonus payments are not intrinsically wrong and can benefit companies if structured correctly.

6. Concerns about excessive executive pay should not be dismissed as a momentary media obsession that will soon fade away. The global economic crisis has raised real questions about how modern executive pay practices – especially extravagant bonuses that seem disconnected to a company's actual health – can encourage a focus on short-term results and the taking of risks that are not always understood.

7. The system can be fixed. Companies should start by redesigning remuneration systems so that they match their long-term strategic objectives, and by taking more care to communicate their policies clearly.

8. Bonus systems should be designed to encourage behaviours that benefit the long-term health of companies, mixing immediate and deferred payouts.

9. Companies must refine how they communicate their executive compensation systems, especially in the context of the annual report.

10. The independence of the remuneration committee is a key mechanism for counter balancing and challenging pay schemes put in place by senior management.

Recommendations

Incentive scheme design

1. Executive pay policies should be designed with a clear link to a sustainable business strategy, with bonuses that are proportionate and linked to performance and risk.

2. Fixed and variable elements of any remuneration plan should be balanced, with the fixed elements sufficient to attract the talent required for a position.

3. Some part of any bonus scheme should be forward looking and part of the award should be medium or long-term in nature, such as through deferred pay that varies with performance during the deferral period.

Effective public reporting

1. Include a high level summary within the executive remuneration report to stakeholders that details the key qualitative and quantitative information.

2. Avoid obtuse language or cut-and-paste passages that obstruct clear communication of the report's main messages. First and foremost, the remuneration report is a communication tool; regulatory compliance is essential but a secondary consideration.

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Introduction

In the mix of factors that triggered the global financial crisis in 2008, executive bonuses that encouraged the philosophy of short-term success had a major role. Performance pay, particularly for top executives, represented the majority of a manager's total pay at many companies. And often, performance was judged by measurable data such as sales figures or share prices. Yet, these metrics fail to take into account longer-term risks being carried by financial institutions and other companies. Our analysis suggests that there is a better model that focuses more clearly on sustainable corporate health.

The Financial Stability Forum, a group founded by the finance ministers and central bankers of the G7 countries and succeeded by the Financial Stability Board in 2009, concluded that executive pay systems at financial institutions were historically unrelated to the amount of risk being passed on to the company. The forum recommended tighter regulatory oversight to assure alignment becomes more appropriate.

High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms.

'High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms,' the report said. 'These perverse incentives amplified the excessive risk taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialised. The lack of attention to risk also contributed to large, in some cases extreme, absolute levels of compensation in the industry.'

Large remuneration packages, often with bonus pay representing the bulk of total remuneration, has become an established practice in western economies. These pay structures are prevalent in the UK and the US, but less common in continental Europe. For many, these systems are considered an integral part of corporate performance management. According to this view, significant performance-related pay elements or bonuses are needed as incentives for individuals with a direct impact on an organisation's success.

In developing markets, particularly India and China, performance-based pay has also picked up momentum. Brought in as best practice by multinationals or adopted by domestic powerhouses wanting to establish themselves in global markets, performance-based systems are seen as tools for breaking away from corporate cultures that obscure individual responsibility and reward personal achievement. In 2009, The Asian Banker magazine published a list of the top 50 bank chief executive officers in Asia based on remuneration. The CEOs at 14 Chinese banks and seven Indian banks made the list, up from seven in China and two in India just two years earlier.

And it's not just a private sector issue

The spotlight on pay will not just fall on the private sector – with the current tendency to use the Prime Minister's salary as a benchmark against which to measure other public sector pay heightening interest.

It will therefore be just as important for the remuneration packages of senior officials and executives in the public sector to be designed effectively and communicated in a clear and concise way.

The public sector has the added complication of politics. Political considerations may lead to a freeze on bonus payments in some areas of the public sector; this will make it more difficult to motivate staff and have an adverse effect on performance management.

The list is dominated by bankers in Australia, Singapore and Hong Kong, with remuneration for mainland Chinese and Indian bankers being relatively low. For example, despite being among the top five banks globally in terms of market capitalisation, Industrial and Commercial Bank of China (ICBC), China Construction Bank and Bank of China, ranked 45th, 41st, and 44th respectively. Although ICBC is the world's biggest bank in terms of market capitalisation, its CEO pay was just 3% of that paid to Australian ANZ's CEO that year. Interestingly, performance-based pay accounted for just over 50% of ICBC's CEO total remuneration, compared with 72% at ANZ. Bank of China, the only other Chinese bank on the list to detail its CEO pay, showed bonuses made up 64% of CEO pay, which is more in line with other bankers in the ranking.

In addition to being linked to the global crisis, excessive CEO compensation has also been attacked in terms of fairness. Of course, concerns about just remuneration for leaders are not new. As early as the 4th century BC, Plato reasoned that the best paid earners in an organisation should get no more than five times that of the lowest paid. Centuries later, management guru Peter Drucker argued that a more appropriate ratio would be 20:1. But in the UK, for example, in 2009 the average pay of CEOs of the 100 largest companies received 81 times the pay of the average worker, according to a report from Income Data Services, a group that monitors remuneration. In the US, a 2009 report from the Economic Policy Institute said that in 2006, CEOs made 271 times the salary of average workers.

'The level of executive pay is a total and complete scandal,' argues Roger Bootle of Capital Economics. 'There is a real crisis of capitalism about all this. Where people are paying themselves tens of millions of pounds, it adds up to a form of expropriation.'

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At the extreme end of criticism, Henry Mintzberg, a professor at McGill University in Montreal, Canada, wrote in *The Wall Street Journal*: 'When you look at the way the compensation game is played – and the assumptions that are made by those who want to reform it – you can come to no other conclusion. The system simply can't be fixed. Executive bonuses – especially in the form of stock and option grants – represent the most prominent form of legal corruption that has been undermining our large corporations and bringing down the global economy. Get rid of them, and we will all be better off for it.'

While imbalanced executive pay programmes linked to immediate, measurable corporate gains encourage a shorter-term view of company health, shareholder structure also exacerbates this tendency. Hedge funds and retail investors, for instance, too often focus on winning quick returns from their investments. Charlie Mayfield, the chairman of the UK's much admired John Lewis Partnership, said recently that shareholders have a responsibility to rein in executive pay, but lamented: 'they don't act as responsible owners anymore.'

There is a lack of longevity in the relationship between shareholders and the businesses in which they have invested. Nowhere is this more evident than in the recent Kraft takeover of Cadbury, where a number of hedge funds had taken a position in Cadbury shares on the basis that they thought the company would be sold rather than on the basis of whether they thought the business should be sold.

The impact of misaligned remuneration practices goes much deeper than a few individuals reaping enormous gains from the system. Big cash bonuses can undermine corporations by hollowing out the business. The quest for immediate short-term gains (and the bonuses they bring) can overtake concerns about a company's sustainability. Risks that won't be realised for years, or even decades, are shunted aside in the effort to meet key performance indicators. The Financial Stability Forum noted: 'As a practical matter, most financial institutions have viewed remuneration systems as being unrelated to risk management or risk governance.'

A more responsible system would focus on an organisation's strategic long-term goals and allow for meaningful annual incentive payments that do not conflict with these objectives. Furthermore, the system would be transparent and communicated clearly to stakeholders. It shouldn't hide behind pages of legal text, as is the case in many developed countries, or simply go unreported, as is the case in some developing markets.

Realigning remuneration systems

In light of such criticism, efforts at all levels are under way to re-align corporate remuneration systems, with a clear focus on the much criticised financial services industry. Multilateral government bodies such as the recently reconstituted Financial Stability Board, national groups such as the Walker Review led by David Walker in the UK, and individual companies are all trying to get ahead of the upcoming wave of reform.

The amount of executive pay that could be affected by these efforts is huge. On Wall Street in the US alone, bonuses for 2009 totalled just more than $20bn, a 17% increase on 2008, according to the New York State Comptroller. In the UK, a special tax on annual bonuses of more than £25,000 is expected to bring in more than £2.5bn in state revenues, the Financial Times estimated.

The British 'supertax' and a similar surcharge in France are precursors to efforts by regulators in other countries to dampen bonus payouts or at least generate public revenues from them. In the US, a proposal is being considered to levy a 50% tax on annual bonuses of more than $50,000 at banks that received federal bailout money, while the Obama administration has called for a general tax on all large banks. Even in China, the Banking Regulatory Commission has imposed a ceiling on bonuses of three times base salary and told banks to hold 40% of bonus payments against potential future risks.

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In 2009, the Financial Stability Forum issued nine principles for sound compensation management, focusing on governance of pay systems, aligning compensation to risk, and guidelines for governments and effective oversight. The Walker Report for the UK Treasury also made a number of recommendations for improving the remuneration system in the British financial industry. (See box for highlights of these reports.)

The Walker Report emphasises the importance of the role of the remuneration committee and this was recently highlighted at Royal Dutch Shell. In May 2009 60% of shareholders voted against the remuneration report at the Shell AGM. Although this was a non-binding vote it was clear from the strength of the dissent that a wholesale review of Shell's executive pay policies was needed. The remuneration committee was tasked with this review and over the next months entered into extensive dialogue with major shareholders and corresponding changes to remuneration of senior executives. The remuneration committee was instrumental in being able to review and provide clear guidance to the board on the appropriateness of any proposed changes and the overall levels of remuneration.

Individual companies and executives have also proactively adjusted their remuneration systems. Chief executives at Lloyds Banking Group, Barclays Bank and Royal Bank of Scotland have together waived more than £5m in bonus payments. ING, the Dutch banking and insurance group, announced in February that it would limit executive bonuses to one year's fixed salary. Goldman Sachs in the US cut the 2009 bonus paid to its chief executive to $9m, down from $68.5m in 2007.

Bonuses, correctly structured, have a positive impact on employee behaviour and can be useful incentives.

Some companies have also begun reconfiguring their executive pay systems, trying to find a balance between cash payments, stocks and stock options, and other mechanisms that delay payouts. Clawbacks – taking back incentive payments that have already been awarded – are also being implemented or considered as companies look for ways to better match performance-related pay with longer-term risk.

Bonuses, correctly structured, have a positive impact on employee behaviour and can be useful incentives. The best talent gravitates toward higher remuneration, and these valuable workers are essential for a successful company. Bonuses can also encourage alignment of interests of the executive and the organisation and its key stakeholders.

And it is not all about top executive pay. The recent announcement of a £151m bonus pot to be paid by the John Lewis Partnership in the UK has generally been welcomed, and is widely regarded as a significantly positive motivational tool among its 70,000 employees, who own the business and whom they call 'partners'.

However, executives could find it difficult to distinguish necessary changes in remuneration policy from unnecessary (and potentially harmful) reactions to public criticism.

Our analysis shows that two aspects of compensation – the overall design of the programme and its transparency – are critical first steps in reviewing these systems.

Financial Stability Forum – principles for sound compensation practices

Governance:

- the firm's board of directors must actively oversee the compensation system's design and operation
- the firm's board of directors must monitor and review the compensation system to ensure the system operates as intended
- staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business area they oversee and commensurate with their key role in the firm.

Alignment with risk taking:

- compensation must be adjusted for all types of risk
- compensation outcomes must be symmetric with risk outcomes
- compensation payout schedules must be sensitive to the time horizon of risks
- the mix of cash, equity and other forms of compensation must be consistent with risk alignment.

Supervisory oversight:

- supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action
- firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

Walker Review – key recommendations on remuneration in UK banks

- The remuneration committee should ensure that the company is adopting coherent remuneration policies in respect of all employees.
- Remuneration reports should disclose in bands the number of 'high end' employees, including executive board members, earning in excess of £1m. [The threshold adopted was reduced to £500,000.]
- The committee should confirm in respect of 'high end' employees that it is satisfied that performance objectives and risk adjustments are reflected in the compensation structures.
- Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance.
- If a non-binding resolution on a remuneration report fails to attract 75% of the votes cast, then the committee chairman should stand for re-election in the following year, irrespective of their normal appointment term.

Designing integrated remuneration systems

Executive pay systems should not sit in isolation from the rest of the organisation, but must be an integral part of a company's business model. Executive compensation must strive to provide incentives and motivation for executives and other staff to act in the best long-term interests of the business. In addition, these systems must be fair and proportional to the actual effort and success.

Proportionality is especially tricky. Wall Street banks are expected to post profits of around $55bn for 2009, a figure that would have been far higher if roughly $20bn in bonuses had not been paid out to staff. Does the value added by the recipients really account for almost a third of these banks' profits? Most probably not. Yet how does a company separate individual efforts from the value brought by the company's own assets, such as capital, security, reputation and economies of scale? Even business units that have been particularly successful profit to some degree from being part of a larger organisation.

There is no universal yardstick that shows when remuneration is correctly proportionate to effort and value.

There is no universal yardstick that shows when remuneration is correctly proportionate to effort and value. The Financial Stability Forum emphasises that human judgement is as essential as quantitative measurements in designing appropriate risk adjusted pay systems. A first step toward finding proportionality, however, is to seek the correct balance between the fixed and variable elements of any plan. The fixed elements should be sufficient to attract the talent needed for a particular post even if the variable element – performance-based bonuses – is withheld because an employee fell short of pre-determined targets.

The variable portion of total pay should be linked to targets that can be affected by an individual's performance, as well as the overall success of the company. Generic targets are much less effective than those set with a clear understanding of how a specific position contributes to the overall strategic objectives of the organisation. Inappropriate targets can too easily foster a culture of short-term gains and long-term risk. While immediate success, including market and revenue gains, should be rewarded, these targets should be augmented by goals such as multiple year gains that more closely reflect the sustainability of these successes.

And just as the time horizon for individual targets must be varied, the composition of the bonus payouts themselves should be mixed to reflect short, medium, and long-term achievements. A scheme that leans heavily on cash payouts quickly promotes short-term thinking. Equity rewards give individuals a greater interest in the long-term success of a company, but also distance individuals from the value of their efforts, since stock prices reflect market sentiment rather than personal achievement. Other instruments, such as pension contributions, could also be part of the mix. The critical measure is to have a portion of variable pay that can be deferred and then released as longer-term successes are realised.

Reporting with clarity

In many annual reports, information about remuneration for the chief executive and other top managers is hidden in plain view. The figures and philosophy behind compensation plans are obscured in a thicket of legal jargon and cut-and-paste, pro-forma language. As Christopher Cox, then chairman of the US Securities and Exchange Commission, observed in 2006: 'no shareholder should need a machete and a pith helmet to go hunting for what the CEO makes.'

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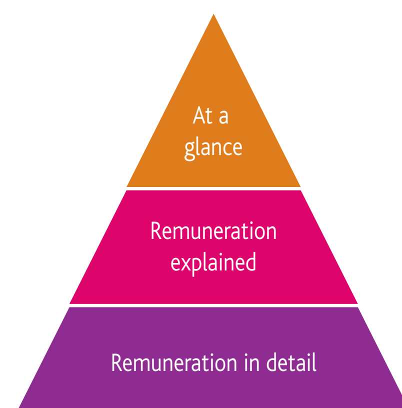
Effective reporting is essential, especially during the current global economic turmoil when executive compensation is at the centre of the maelstrom. Stakeholders need clear, accurate information to make informed resource allocation decisions. Regulators are demanding ever greater disclosures. Dense, unclear, legalistic prose invites suspicions that a company is hiding something; that it is following the letter of the law, but not its spirit.

The challenge facing companies is to document executive compensation in a way that balances the legal need for voluminous detail and transparent information. The report leadership team, a partnership between CIMA, PricewaterhouseCoopers and Radley Yeldar, a communications consultancy, has talked with investors about what they want when they turn to the executive remuneration section of an annual report. Their needs were clear:

- a description of the overall policy, principles and purpose behind each element of pay
- a prominent display of the main elements of pay and how they were calculated
- an explanation of how strategic aims are reflected in executive rewards
- details of how executive rewards are aligned with the shareholder interests
- an explanation of how under performance could affect executive compensation
- clear messages backed by evidence, including comparisons with relevant peer groups.

To improve communication between companies and shareholders about executive compensation, the report leadership team suggested a three tier report, with each section delving deeper into the nuances of executive pay policy. Such report would offer the clarity needed to assure stakeholders of the rationale behind compensation practices, as well as the minutiae required for legal compliance.

The recommended report template begins with an 'At a glance' section, primarily a letter from the head of the remuneration committee. The letter would explain the committee's work from the past year and any significant decisions that were made. Its focus would be to address concerns from shareholders, such as those raised in the bulleted section above. A synopsis of key information, both qualitative and quantitative, would supplement the letter.



The next section, 'Remuneration explained', would examine how the company pay practices are structured. It would look at how performance affected board member and executive compensation. In addition, it would present any anticipated changes to the company's remuneration policies. The information would be presented in a clear, easily accessible format.

The final section of the report, 'Remuneration in detail', would take a magnified look at the compensation awarded for the past year, offering the various disclosures required by legislation and regulation. Although by necessity this section goes into the finer points of the policy and its outcomes, companies should strive make this section accessible and informative.

Real life examples

Some companies have already begun issuing clearer remuneration reports along the lines suggested by the report leadership team. Here are some examples of good practice reporting from actual published accounts.

Aviva Plc

The directors' remuneration report from Aviva's 2009 annual report starts with a high level review of the remuneration year in the form of six key highlights. The report then builds upon this foundation in a progressive manner, covering the following elements:

- the remuneration committee's objectives, membership and main activities
- a review of the company's remuneration policy and practice
- commentary on the alignment between remuneration and business strategy and objectives
- details of the terms of executive directors' service contracts
- company policy on external board appointments
- all employee share plans and share incentive schemes
- tables summarising executive pay, pensions arrangements, share incentive plans and directors' interest in shares.

The idea of deepening the level of information as the report progresses follows the principle of the multi layered report leadership approach, which allows the reader to dip into the report only to the extent needed to extract the information required. The task of wading through reams of boilerplate text to find what you want is removed.

BAE Systems Plc

BAE Systems presents key remuneration information effectively by providing an 'at a glance' summary of its remuneration strategy and policy linking the various pay package elements to their individual purpose.

Throughout the report it uses tables and charts to break up dense text and provides graphical analysis of the performance drivers of the overall incentive package. A clear explanation of how the variable elements of reward align with the group's key performance measures makes this report a useful example of how an effective remuneration report can be structured. This report illustrates that the principles of good remuneration reporting, contained within the Report Leadership publication, can be adopted in a variety of ways depending on the particular circumstances and preferences of the reporting company. What is needed is a commitment to effective reporting.

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- *Complexity, relevance and clarity of corporate reporting: the views of FTSE 350 Directors*, CIMA, 2009

All are available from **www.cimaglobal.com**

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Notes

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