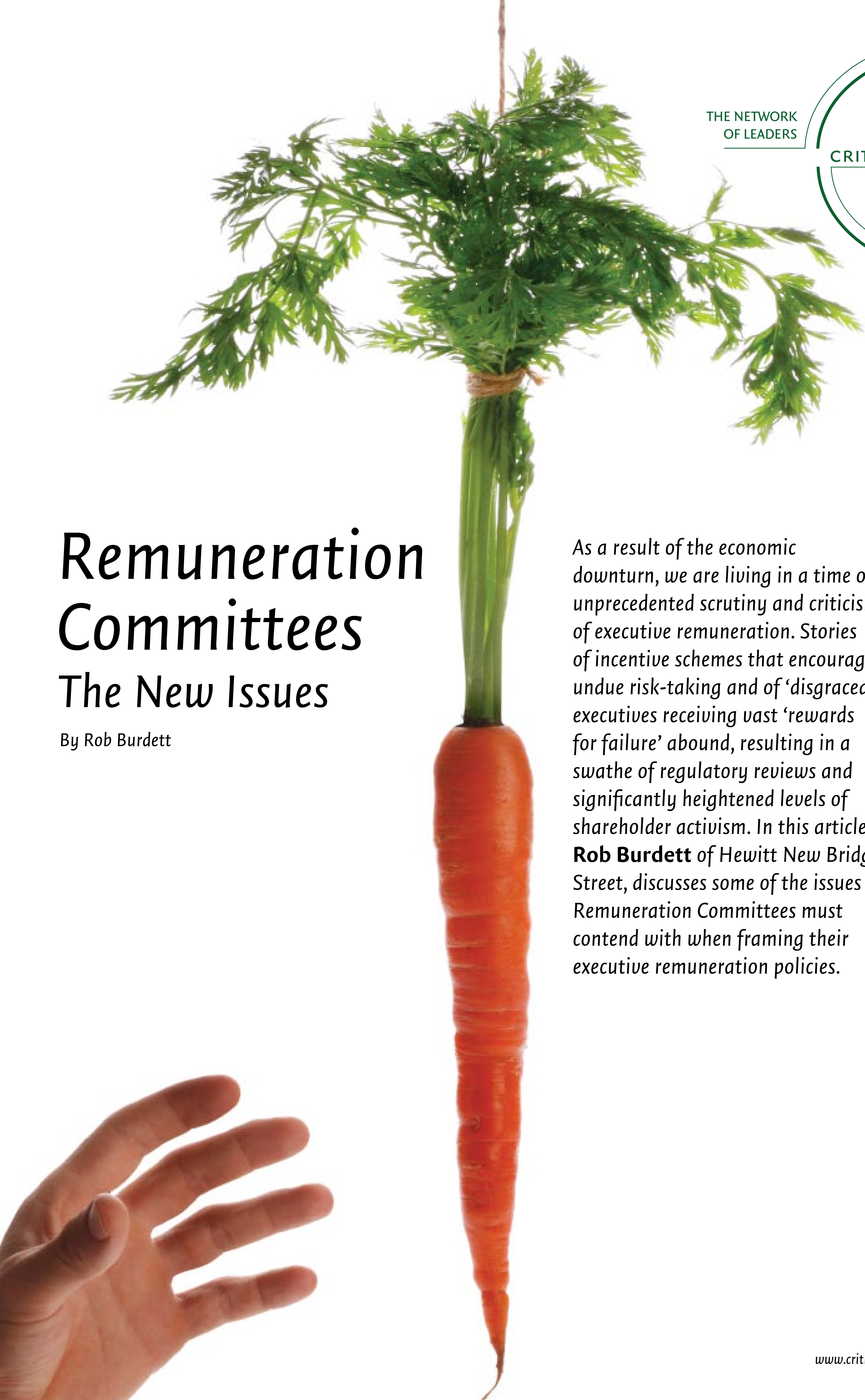

Remuneration Committees
The New Issues

By Rob Burdett

As a result of the economic downturn, we are living in a time of unprecedented scrutiny and criticism of executive remuneration. Stories of incentive schemes that encourage undue risk-taking and of 'disgraced' executives receiving vast 'rewards for failure' abound, resulting in a swathe of regulatory reviews and significantly heightened levels of shareholder activism. In this article, **Rob Burdett** *of Hewitt New Bridge Street, discusses some of the issues Remuneration Committees must contend with when framing their executive remuneration policies.*

To many, this criticism and heightened activism has come as something of a shock as, before the recession, a degree of consensus appeared to have emerged regarding how best to structure an executive's pay. While there was some disquiet that levels of total remuneration were increasing, comfort was taken from the fact that this was mainly through higher potential bonus and/or larger long-term incentive awards. Pay was becoming more performance-related.

However, this consensus has been challenged. As a result of this febrile environment, Remuneration Committees have much to contend with when framing their executive remuneration policies. As far as regulatory oversight is concerned, the FSA has been a key player. While the FSA's Remuneration Code only purports to have direct applicability to financial services companies, some of the Code's recommendations are likely to be embraced more widely. A key theme of the FSA - and other commentators - is the issue of 'risk', with companies across all sectors now encouraged to disclose how it is reflected in their pay practices. As a result, many companies have felt the need to conduct a formal 'risk audit' of their executive remuneration policies, where they 'stress test' their pay practices to ensure:

- There is a sensible balance between fixed and performance-linked pay (i.e. packages are not over-geared, thereby encouraging risky decision-making).
- The performance-related elements of pay do not encourage 'short-termism' by a heavy weighting on annual bonus.
- The targets themselves are (where possible) risk-adjusted and appropriate input is sought from the Audit Committee on these targets.
- There is appropriate means of redress if there is an overpayment of bonus.

Also, changes to the Companies Act now require Remuneration Committees to explain how they have taken broader all-employee pay and conditions into account when setting the executives' remuneration, although there is no agreed view as to precisely what information this requires a company to disclose. In fact, this whole issue of the relationship between the pay of Directors and the workforce has begun to attract greater prominence. Unfortunately, the problem with disclosing information on the relationship between executive and workforce pay levels is that it is very difficult to make robust comparisons between sectors, and even harder to apply a 'one-size fits all' judgement as to what constitutes

COMMUNITY COMMENT

Joe Darby, Non-executive Director, Premier Oil plc

"In my view, the major challenge facing Remcos is the link between pay and performance. While general consensus has been reached in recent years on the principles governing best practice in structuring executive pay - mainly the link between pay and performance - putting this into practice has remained elusive. The common mantra is superior pay for superior performance but, more often than not, superior pay is being received for rather average performance. It is rarely the other way round. In some instances, very generous payments are made for exceedingly poor performance. There are many reasons for this including:

- bonus targets are not challenging enough. There once was a time when bonuses were only paid for performance better than the base budget and plan or for achieving some significant strategic goal. Now it is more common for half or more of the maximum bonus to be paid for achieving the base budget and plan. This means that bonuses have essentially become part of base salary. This needs to be addressed with high levels of bonus only being paid for achieving demanding stretch targets.

- the rate at which overall levels of remuneration are increasing. A reason for this is companies' desire to remain competitive in their sectors and enable them to 'hire, retain and incentivise' their executives. This has resulted in the ratcheting up of executive remuneration packages to levels that are now probably too high. I would like to see the competitive element de-emphasised and the objective of 'ensuring that pay is fair and reasonable and related to value-added with proper reflection of risk' being given much more prominence.

- the use of relative measures in share schemes which often allows awards to be made where performance relative to a comparator group is above the median, but where absolute performance has been poor and, in some cases, value eroded. In this regard, the award of performance shares as opposed to conventional share options aggravates the problem. One way round this is to impose additional conditions relating to absolute performance.

- inappropriate executive employee contracts with terms providing for over generous payments where such contracts may be terminated early, even for very poor performance leading to take-over, government bail-out or major refinancing. Contracts must be tightened to prevent payments in such circumstances or to provide remuneration committees with the right to exercise restraint."

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COMMUNITY COMMENT

Ruth Cairnie, Non-executive Director, Keller Group plc & Vice President Commercial Fuels, Shell

“The focus on executive pay in the past several years has delivered more transparency, objectivity and robustness. There is much more convergence and clarity about what constitutes a good scheme. No doubt many anomalies and misaligned programmes have been phased out as a result.

However, all this attention has also brought a number of less desirable consequences.

First, pay has become over-stated as the single transparent way to recognise senior executives. It is much more difficult to articulate and measure all the other ways of valuing, and adding value for, executives. Thus, pay risks becoming an obsession – at the top end it is very doubtful that money itself is a motivator but the implied recognition definitely is.

Second, the intense scrutiny has led to schemes built on whatever objective, auditable measures of performance are available, leading to the emphasis on short-term financial performance. Longer-term schemes, deferrals, etc are good ways to protect longer-term vs short-term profit, but there is the risk of too much convergence and the approach being too linear. As well as financial indicators, performance should include progress on key strategic objectives, culture change or whatever the most critical issues for the long-term health of the specific company are. Each will be different.

The biggest challenge facing Remcos is to have the courage to drive what works best for the individual company in setting the right performance measures, the right level of ambition in targets and fairness and integrity if discretion needs to be used in evaluation. The right approach cannot be determined by consensus across the whole market.”

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an appropriate relationship between, say, the CEO’s package and average employee pay. This is because the relationship of course varies enormously between sectors. This does not necessarily mean that one sector ‘overpays’ its CEOs more than another. Instead, the discrepancies are more likely to be driven by the fact that the average worker in one industry will have very different skill requirements - and therefore earning potential - than another.

And all this comes in the context of a certain amount of disgruntlement on the part of some executives. Notwithstanding the fact that, to a large extent, a two-year freeze on executive salaries has been imposed - during a period when past long-term incentive grants have been unlikely to deliver much (if any) value due to the economic downturn - accusations of ‘fat cattery’ continue to abound. That said, some would argue that companies should not be surprised at the continued criticism as bonus payouts still remain higher than many consider appropriate. For example, there has not been one year in the last eight that the median bonus of the Highest Paid Director of a FTSE 100 company has been below 50% of the maximum (the typically disclosed ‘target’ level of bonus opportunity), with over 70% of the maximum paid in five out of the last six years. Shareholders are using use this as evidence of a need for even greater levels of transparency and tougher targets – including mandatory retrospective disclosure of these targets.

Indeed, at the height of the downturn, when City trader-style bonuses were being accused of bringing the global economy to the brink of collapse, it was argued that the entire ‘pay for performance’ model was, at best, a sham and - at worst - a genuinely malevolent force. However, as equity markets (if not necessarily domestic economies) have come onto a more even keel, the mood has changed somewhat. Consequently, the basic premise that a significant (but not excessive) portion of an executive’s package should be linked to performance has been broadly accepted.

As a result, companies have returned to the age-old question of how to measure and reward performance, particularly long-term performance. The vast majority of long-term incentive plans (LTIPs) currently operate in a fairly tradition manner - regular annual awards are made that vest three years after grant, subject to EPS and/or relative TSR targets. However, some companies are now challenging this approach and we are starting to see more innovative thought given to the performance conditions used.

The use of private equity style ‘value creation’ plans is also being considered by some companies, where a larger ‘one-off’ award is made with an absolute target set (perhaps based on share price,

COMMUNITY COMMENT

Jeremy Small, Group Company Secretary, AXA UK plc

"Regardless of whether the economy is in a downturn or not, the challenge for Remuneration Committees remains the same: how to reward executives for meaningful performance in the delivery of their company's strategy. In response to increased scrutiny and the reputational damage associated with ill-conceived incentive schemes, this means re-considering what it is that executives are being incentivised to do and a good starting point would be to establish the nature of the value that achievement of the company's strategy will create, how that is to be measured and how progress to deliver it can be evaluated.

Once this has been established, the Remuneration Committee can decide what its remuneration philosophy should be regarding both compensation and recognition of individual's achievements, complying with legislative and regulatory requirements and taking into account appropriate timescales that will depend on the company's position relative to its sector and the maturity of its strategy.

In my view, key to this is the creation an incentive structure that will lead to sustainable performance that is realistic in the longer-term. Too many schemes have focused on the short-term metrics and a perceived need to keep up with executive remuneration at other companies. This has also led to the establishment of many similar schemes that will produce payouts of similar size using similar measures; the only difference being the numbers used to calculate the outcome. There is a clear need to balance variable compensation with acceptable levels of risk and for it to be proportionate to the scale both of what has been achieved and the remuneration of staff.

It is incumbent on the members of Remuneration Committees to use their judgement to decide what will incentivise their executives to deliver the strategic ambitions set by the board. This means tailoring schemes to their specific circumstances and taking much less notice than has been the case previously of the arrangements that other companies have. I hope that we see real and sustained innovation in the creation of performance targets that are truly tailored to reward outperformance because it is that which shareholders should really recognise."

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profit or some other metric). Once this absolute target is achieved, executives can share in any outperformance - possibly on an uncapped basis - with rewards delivered in either cash or shares.
It is very refreshing that companies are looking at alternative approaches and are willing to defend them robustly to their shareholders. However, many may still consider that a more 'tried and tested' route remains appropriate, provided that this approach still takes full account of the company's particular circumstances. If it does not, the pay policy will not resonate with executives and, in turn, will neither drive nor reward the right behaviours.

In any event, irrespective of the specific approaches adopted by companies, there are some key issues that virtually all Remuneration Committees will need to address given the current economic, political and regulatory climate:

- Are annual base salary reviews necessary, or does this just fuel a pay ratchet?
- If above target bonuses are paid year-on-year, are the targets really tough enough?
- Do both the bonus and long-term incentive targets reflect corporate strategy?
- Has the issue of risk been fully taken into account (while recognising that not all risk is necessarily 'bad')?
- Do award levels (whether they be bonus out-turns, long-term incentive grant levels and/or vestings) genuinely reflect the overall circumstances of the business (including recent financial performance, current share price and expected future growth)?
- Can the pay policy be justified to all stakeholders – investors, customers, suppliers and the workforce as a whole?

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Rob has worked in the field of executive remuneration and share plan consultancy for nearly 15 years. He is a qualified solicitor, has worked in leading City law and accountancy firms and has wide experience in the design and implementation of executive remuneration packages and UK and international equity-based incentive arrangements. Rob sits on the Aon Hewitt Global Executive Compensation Council and has responsibility for the relationship between the UK and North America Executive Compensation practices.

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