ecoDa FORUM
Round table discussion

European Boards Speak Out

Executive pay : getting it back on track

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Executive pay: getting it back on track

Overview of the round table discussion organized by ecoDa[1] on the 22nd of October 2008 in Brussels

By Florence Autret, journalist

The best possible design of an executive remuneration package used to be a topic only for directors, shareholders and eventually consultants. The financial crisis and the massive public response it aroused have turned it into a political issue. As some big financial institutions appeared to owe their survival to public authorities, the opinion blamed their sacked chief executives for cashing six-digit checks. They understandably estimated that it was not the most evident way to endorse full responsibility for the fate of their former company. Unsurprisingly, the political response to this indignation has been ‘regulation, regulation, and more regulation’.

It is very unlikely that this promise to legislate remains limited to the financial industry. All sectors will be impacted, all the more that the media have developed a growing interest for the CEO's remuneration packages over the last years and ensured them great publicity. Thus, in addition to be an all but simple corporate governance issue, executive pay will remain high on the political agenda in 2008 and 2009. Quite timely, the European Confederation of Directors’ Associations (ecoDa) invited four experts (*) to exchange their views and experiences as shareholders and directors and anticipate the unavoidable political debate and regulatory initiatives that will come up both at European and national levels. The roundtable discussion took place in Brussels on October 22nd.

[1] The European Confederation of Directors’ Associations, http://www.ecoda.org/

The political issue

"The downside is not felt by executives. They got one million a year and the worst they can get is two (millions) to leave!" put bluntly a participant. The malaise came mostly as some executives resigned and, at the same time, asked for the benefit of their severance pay which was contractually set up. Miles Templeman, EcoDa's chairman, British Institute of Directors (IoD)' director general and moderator of the panel, considers that "the really painful part for the public is not the pay itself, but much more the failure to penalize failure". This feeling of unfairness obviously collides with the basic principle of contractual security. But public authorities might prefer to address the former rather than guarantee the latter. Axel Miller, former chief executive of Dexia, renounced to cash the two million euros that was included in its remuneration package when he took over the job. Finance Minister Christine Lagarde explicitly made the point while announcing the capital injection. The issue of the proportionality between the merits of an executive and the performance of its company, on the one side, and his remuneration, on the other, is not a new one. New, however, is the fact that, in the future, it might have to be solved in public under the scrutiny of the public opinion and authorities.

The debate will for sure go beyond severance pays and hit more remuneration policies as a whole. Germany and France announced that they would closely monitor remunerations in companies that benefited from public support in the aftermath of the financial turmoil. The criteria and means they will resort to do so remain vague. Will they use their rights as shareholders? Will they use some contractual means in submitting the access to public money to certain conditions? Will they prefer to go down the legislative road? Whatever the answer, remuneration being now a *public* issue, it has to be addressed *in public* be it by legislators, treasuries or the industry. "There is so much hostility that we know that doing nothing is not an option… We should have our house in order", said Lutgart Van den Berghe, chairwoman of the policy committee of ecoDa, executive director of GUBERNA. In a sense, shareholders, boards, executive and non-executive directors have a common interest in appropriately addressing these concerns, as legislative intervention will certainly reduce their scope of maneuver. The more political factors will be put in the remuneration's equation, the higher its complexity. "If you get government in, it leads to an absolute minefield", said Miles Templeman.

Pressured by some member states, Brussels is about to take action. "We will come forward with an initiative on executive pay", said José Manuel Barroso, head of the European Commission, in Milan on October 31st. It is foreseeable that Member States will maybe not wait until these proposals are on the table to reshape their own regulations.

In the financial sector, however, national authorities have begun to demonstrate some willingness to cap salaries. Notably, the German government requires from banks that want to benefit from its support plan to limit the pays of their executives to 500 000 € annually. (In the US, the Republican presidential candidate, John McCain, has taken the same stance regarding CEOs of bailed-out companies, the limit being about 400 000 USD). The British Financial Services Authority has asked the banks to review the possible perverse effects of their remuneration policies in terms of risk-taking and financial stability. The need to review remuneration policies of financial intermediaries is explicit in the conclusions of October's Ecofin Council.

Shareholders, board and executives: looking for the best possible balance of powers

"We are large, long term holders of companies. We consider ourselves as owners. So we need to keep some integrity in the process", said Peter Montagnon, director of investment affairs at the Association of British Insurers. ABI, whose members are major active shareholders, implements a thorough self-regulation policy by advising its members on the design of remuneration policy. "In the UK, we have always had an active discussion about remuneration", he said. It was enhanced when the government introduced mandatory requirements about the disclosure of remunerations, and an advisory vote of the general meeting on remuneration policy. "This has encouraged us to have more dialogue and enabled us not to avoid large confrontations", said Peter Montagnon.

Box 1: Executive Remuneration – ABI Guidelines on Policies and Practices

Regarding the current economic climate, the ABI would like to draw attention to the following points:

- The remuneration policy should be fully explained and justified, particularly when changes are proposed. Members will carefully scrutinize remuneration uplifts, particularly increases in salaries or annual bonus levels.
- Where a company has underperformed and seen a significant fall in its share price, this should be taken into account when determining the level of awards under share incentive schemes. In such circumstances, it is not appropriate for executives to receive awards of such a size that they are perceived as rewards for failure.
- Shareholders are generally not in favor of additional remuneration being paid in relation to succession or retention, particularly where no performance conditions are attached.
- In the context of the consultation process for share incentive schemes, Remuneration Committees should ensure that shareholders have adequate time to consider the proposal and that their views are carefully considered. Relevant information related to the consultation should be clearly and fully disclosed.

For further information please go to:

http://www.ivis.co.uk/ExecutiveRemuneration.aspx#sectionone

While the UK is unanimously considered as exemplary in the way it delivers effective self-regulation, the Continental European approach seems to be more debatable. The make-up of the remuneration committee, including the presence of non-executive directors, hasn't entirely sheltered it from endemic conflicts of interest. Two-thirds of countries do not have any form of shareholder vote on remuneration. "Comply or explain is a satisfactory solution for companies", said Lutgart Van den Berghe, "but if you look at the explanations they sometimes aren't explaining much!"

In this context, stronger shareholders' rights and activism might be helpful. "Advisory votes give non executive directors the power to say 'no' ", added John Carney, managing principal of Towers Perrin's executive pay practice in Europe. "The remuneration committee members will feel more empowered if they feel that shareholders will vote on it", said Jean-Nicolas Caprasse, head of Governance Services, EMEA, RiskMetrics Group. But he also pointed out the major differences between European countries and an apparent reluctance to implement EC recommendations.

According to the proxy adviser Riskmetrics[2], remuneration was the second of the top 3 items that happened to receive the higher level of dissent during the general meetings of 715 big European companies in 2008. Share plans are particularly debated. Its statistics shows that 9% of the resolutions were rejected, mostly because of the absence of any performance criteria. Remunerations themselves were also contested, ex post, in many cases, Philips being the more emblematic. Shareholders insisted that there was to be a cap on severance payments.

Shareholders' right to monitor remuneration policy or even more to participate to its design differs from one country to the other. In 2004 the European Commission recommended to reinforce disclosure and empower general meetings. It has been barely implemented. According to Riskmetrics, one can discriminate, within European countries, between those which, like the Netherlands or Sweden, impose ex ante votes on remuneration schemes or packages, those which impose non binding ex post votes on remuneration reports, like in Spain, the UK or Switzerland, and the big majority for which there is no such thing as an advisory vote. Nevertheless, everywhere in Europe, the shareholders are entitled to vote on diluting instruments such as the free grant of shares to salaries.

"Remuneration is a hot topic at the general meetings", said Jean-Nicolas Caprasse. "However reality is more complex, than what comes out of these general meetings. Through a direct dialogue between the main shareholders and the management, which takes place behind the scene before the general meeting, the worst cases can often be adapted or simply withdrawn". "A lot has been accomplished, but much has still to be done to escape legislative intervention", he added.

However, Peter Montagnon doubted that general meetings should play a greater role. "From the outside, you cannot really tell if the remuneration is competitive or not. Shareholders are

[2]RiskMetrics attended about 45,500 general meetings in 2008 on behalf of their institutional clients.

not in a position to impose rules and limits or caps on remunerations. The remuneration committee is more aware of that", he said. The remunerations committee's members "should account for what they have decided", added Peter Montagnon who thus implicitly raised the issue of their responsibility.

John Carney unsurprisingly defended the usefulness of external advice. "Some think that we are part of the problem, others that we are part of the solution", he pointed out ironically. On the 'problem' side, one finds the benchmarking and the kind of ratings of remunerations designed by the consultancy that might encourage the constant rise in remunerations average. The more positive effect is the empowerment of the board and of the remuneration committee, in a situation where "executives have the upper hand, because they have the facts", said John Carney. An external advice can thus enhance the committee's ability to negotiate. "We sometimes have separate meetings with the remuneration committee chair", the CEO him/herself being often a member (although this is not in compliance with the UK Code!) – Still, he insisted that the consultant should remain neutral. "We don't fix pays. It's the company's money. We don't negotiate pay for somebody. We don't take a commission depending on the remuneration", he said.

How much is too much?

A remuneration package must reconcile two possibly contradictory objectives: first, to attract the best possible people, second, to align their interests with those of the shareholders. As participants unanimously put it, the second objective should not be sacrificed to the first. But there is a risk that, even with the best intents, remuneration committees fail to do so. "How you construct the package may have perverse effects", admitted Lutgart Van den Berghe.

ABI's principles precisely aim at establishing a close link between remuneration and performance thanks to a proper monitoring and different incentives one of which being to encourage share incentive schemes. But measuring performance is all but obvious. "How can you be sure that the performance is not manipulated by the management that you promote long term and not go for the short term? How are you sure that you reward long term performance? How do you measure value for the company? It is a complicated issue for which you need the help of independent experts", said Lutgart Van den Berghe. Such an assessment certainly requires again strong and well advised remunerations committee.

John Carney insisted that a good remuneration structure consists in a good mix of shares, long term pay and variable elements. But the maximum level of remuneration escapes the governance issue, he thinks. "This is a social and political problem".

Some participants even wondered if defining a well balanced package was not simply beyond the capacities of a board. "Aren't downsides (of a variable remuneration) higher than upsides?" asked Lutgart Van den Berghe.

According to Miles Templeman, it is the contractual relationship between the company and its CEO that "has to be looked at". "It is too generous", he said. He also underlined the problem of asymmetrical incentives. It might be solved "if we could call back bonuses", he said. Lutgart Van den Berghe suggested some kind of "savings account" to hold and, if necessary, pay back the bonuses.

A major issue nevertheless remains unsolved: the constant raise in remunerations. Peter Montagnon admitted the industry had until now "no ability" to control the perpetual ups of the market. Lutgart Van den Berghe underlined the counterproductive effect that transparency could play in this respect. "Every company is paying above the average because it believes that it performs better than the others. So the average goes up!" she said.

Looking for a sound remuneration policy. Could regulation help?

Both the governance and the political issues that were underpinned above make a strong case for improvements. Can additional regulation contribute to that or would self-regulation be sufficient? The question is somehow theoretical as a regulatory move seems every day more unavoidable. "We must reassure publicly and politically that the market can address these issues." said Peter Montagnon. Jean-Nicolas Caprasse shared this view as he put that, if a regulation might be counterproductive, it might also, if sensible, reinforce internal governance. To reassure politicians and the market, there is still place for voluntary initiatives. However more attention should be made on monitoring the "comply or explain" principle.

The speakers came up with some of the following ideas:

- ***Transparency as a prerequisite***

- Ensure a clear, objective and unbiased view of the structure of the remuneration. Still transparency shouldn't be beyond certain limits. The disclosure of performance criteria might raise serious problems of confidentiality. (Lutgart Van den Berghe)
- Work further on what exactly is to be disclosed: the schemes, the amounts, the details, etc., as the demand for greater disclosure has risen. (Lutgart Van den Berghe)
- Provide true explanations on reasons why to deviate

- ***Shareholders empowerment***

- Organize a systematic annual vote of the general meetings on remuneration schemes as recommended by the EC in 2004 (Peter Montagnon)
- Create some regulatory incentives that make sure that the dialogue between shareholders and companies is *actually* taking place (Jean-Nicolas Caprasse)

- Put all directors, including those on remuneration committees up for annual reelection, so they are more accountable for their decisions (Peter Montagnon).
- Ensure a better information of shareholders before the votes on remuneration schemes (Jean-Nicolas Caprasse)

  - ***Fairer remunerations***

- Introduce a legal possibility to reclaim bonuses from executives that haven't deserved them (Peter Montagnon)
- Ensure that public and shareholders are given evidence of the relevance of the amounts (Lutgart Van den Berghe)
- Confirm and eventually review severance pay limits as is already the case in some member states (Lutgart Van den Berghe)
- Make remuneration committees accountable for their decisions but empower the members to stop demands

  - ***External advice***

- Ask for a code of ethics for remuneration consultants that ensures their independence. (Peter Montagnon)

"Whatever the means, companies and regulators, including the European Commission, have to address the remuneration issue", said Lutgart Van den Berghe. "The political pressure is not going to go away. If the economy goes down and the remunerations keep going up, then things will go wrong".

(*) Participants to the panel : Miles Templeman, chairman of ecoDa, director general of IoD, Jean-Nicolas Caprasse, head of Governance Services, EMEA, RiskMetrics Group, John Carney, managing principal of Towers Perrin's executive pay practice in Europe, Lutgart Van den Berghe, chairwoman of the policy committee of ecoDa, executive director of GUBERNA, Peter Montagnon, director of investment affairs, Association of British Insurers (ABI).