Executive Remuneration and the Latest EU Recommendation

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For a long period of time (basically from the early 1960s to the beginning of the 1990s) the scenario for executive compensation was reasonably stable and predictable. More specifically:

– chief executive pay was a 'reasonable' multiple of rank-and-file employee pay (about 40 times in the USA, much lower in Europe and Japan);

– the average growth of the stock market was in line with the growth in GNP[*] (about 3% per year in real terms)[†] [1]; and

– financial industry compensation levels were very much in line with other industries.

However, being an executive in the 1970s and 1980s was a risky job (Besse, Chief Executive of Renault, Herrhausen, Chief Executive of Deutsche Bank, and Ghiglieno, a top executive of the Fiat Group, were all killed by terrorist groups).

This scenario changed dramatically with the deregulation taking place in many previously regulated industries in most Western countries and, particularly, in the financial industry, which had a great impact. Starting from the mid 1990s the economy and executive compensation experienced a season of excesses, as follows:

- In the USA, chief executive pay rose from about 40 to over 400 times the pay of a rank-and-file employee (mostly due to stock-option plans)[‡] [2] and even in the Nordic countries the multiplier reached over 50[3].

- In several countries the average growth of stock markets became higher than the growth in GNP (largely down to both the dot.com and the structured financial product bubbles).

- Financial industry compensation levels have exceeded, by about 60%, the levels of other industries, though employment in finance has not significantly grown.[§] [4] [¶] [5]

During this period, being an executive was no longer a risk but became a nice platform for a political career (Prodi, former Chief Executive of IRI, became Prime Minister of Italy; and Paulson, former CEO of Goldman Sachs, and Breton, former Chief Executive of France Telecom, became U.S. Secretary of the Treasury and Minister of Finance for France respectively).

The Golden Age of executive compensation ended abruptly with the 2008 financial crisis. To be precise:

– from January 2007 to April 2009 the S&P 500 fell by about 40% and the index of US banks by about 70%[**] [6];

– most of the leading banks have dismissed their chief executives by paying them significant termination indemnities (US$160 million[††] in the case of Stan O'Neal at Merrill Lynch and US$42 million for Chuck Prince at Citicorp) or hefty pension entitlements (equivalent to a lump sum of £17 million[‡‡] for Fred Goodwin at the Royal Bank of Scotland[§§] [7] [8]);

* gross national product
† From 1980 until 2007 worldwide GNP increased, on average, by 3.4% p.a. and, even if the current crisis lasts until the end of 2010, average GNP growth during the 1980-2010 period will remain in the order of 2.7% p.a.
‡ The multiplier in the USA increased from 42 in 1982 to 431 in 2004.
§ From 1948 to 1982 in the USA pay in the financial services industry was in line with the average of all other industries, while subsequently it started to grow at a much faster pace, reaching an index of 181% in 2007 as compared with the average for other industries.
¶ The same trend took place in Switzerland with pay progression in the financial services industry during the period 2000-07 corresponding to 8% p.a. in real terms as compared with average growth of 4.2% in the service sector generally.
** These figures show that the crisis was first financial and only subsequently economic.
†† £1 = US$xx.xx; €1 = US$xx.xx as at 23 October 2009
‡‡ €1 = £xx.xx; US$1 = £x.xx as at 23 October 2009
§§ The annual pension of Sir Fred Goodwin was around £703,000 p.a. corresponding to a lump-sum value of about £17 million, considering that he is about 50 years old. However, under the pressure of public opinion he has agreed to make a partial reimbursement.

– many banking employees have lost their jobs and several million employees in other industries are expected to be made redundant in 2009 as a consequence of the 2008 financial crisis[*][9]; and

– despite this black scenario some financial groups on the verge of insolvency have still paid significant bonuses (US$3.6 billion at Merrill Lynch, SF 2 billion[†] at UBS and US$165 million for AIG executives)[‡] [10] [11].

The quick, strong reaction of governments is also a consequence of the failure in corporate governance. An apposite comment may illustrate:

> "One of America's curiosities is that it has long held public officials to stringent standards while extending extraordinary indulgence to its senior corporate executives… Companies should eliminate all compensation on dismissal other than a year's pay."[12]

A few, more general, points are as follows:

- Remuneration (compensation) committees have failed to control the escalation of executive pay (specifically as far as share plans and golden parachutes are concerned).

- Non-executive board members in the financial industry have been unable to grasp the relationship between company risk and traders / financial specialists' incentive schemes. It has been shown that banks and insurance companies with boards filled by members without specific knowledge of the financial industry experienced higher losses from structured products as compared with other banks and insurance companies whose boards included members with specific experience in the industry.[13]

- Institutional investors have performed poorly in assessing the board members' skills and the board's effectiveness.

This failure is also due to the fact that shareholder value (represented by quarterly dividends and share price gains) was considered the main strategic goal, not a result of the long-term growth of the company. Even Jack Welch, considered to be the 'prophet of shareholder value', recently said, "Shareholder value is a result, not a strategy."[14] Consequently, as long as shareholder value was apparently going up, non-executive board members were very reluctant to challenge poor corporate governance practices.

PUBLIC REACTION TO PAY EXCESS

The outrage of the general public *vis-à-vis* these bonuses has paved the way for government reaction on executive pay in the financial sector. In several countries governments have taken a tough approach, by proposing the following:

- In the United States, a US$500,000 cap on pay has been imposed for the top executives of companies that received Troubled Asset Relief Program (TARP) funds[15] (in addition, the U.S. Treasury has appointed a "special master on pay" with the power to reject pay plans for companies that were the recipients of government bail-out money[16]).

- In France, bonuses in the financial sector will be paid over several years and linked to long-term profitability[17].

- In Germany, a €500,000[§] salary cap has been introduced for executives of banks receiving public funds (in addition, other measures have been proposed, such as longer vesting periods for stock options, variable pay recognized only at the end of a five-year contract and reimbursement of a year's salary in the case of mismanagement)[18].

As expected, the authorities and agencies involved in corporate governance practices have finally reacted in order to contain government action. To be more specific:

– in France, the employers' associations (*AFEP–MEDEF*[¶]) have laid down very specific recommendations concerning directors' remuneration[19];

– in the UK, the Financial Services Authority has presented a proposal concerning hedge fund managers' pay[20];

– in Italy, the Central Bank has produced specific guidelines concerning directors' remuneration in the banking sector[21];

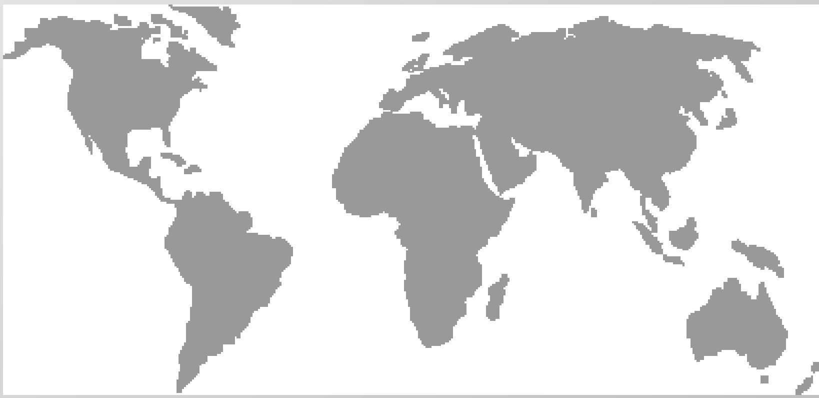
– in Switzerland, the financial markets' supervisory authority has presented a proposal concerning compensation in the banking sector[22].

In general, both government rules and self-regulation guidelines tend to introduce a new approach to executive pay. Such an approach is broadly based on the following principles, which are gradually being adopted in more and more countries:

– chief executive pay as a multiple of rank-and-file employees' pay should be disclosed and justified;

– performance must be rewarded only if it is long term and sustainable and is not linked to excessive risk or too easy market conditions;

* Between November 2008 and March 2009 the number of unemployed in the USA increased by more than 600,000 per month, reaching an unemployment rate of 9.4%, the highest for the last 26 years.
† £1 = SF xx.xx; €1 = SF xx.xx; US$1 = SF xx.xx as at 23 October 2009
‡ The reaction of the public in the USA *vis-à-vis* the AIG bonuses was so strong as to push Congress to approve a retroactive tax of 90% on the bonuses paid by companies that had received public funds, such tax later being withdrawn. Much more contained was the reaction of the Swiss public *vis-à-vis* UBS's 2008 contractual bonuses, even though the bank lost more than SF 20 billion in that year and received financial help of SF 67 billion on top from the Confederation.
§ £1 = €xx.xx; US$1 = €xx.xx as at 23 October 2009
¶ *Association Française des Entreprises Privées – Mouvement des Entreprises de France*



– poor performance should never be rewarded through generous golden parachutes or attractive incentive-to-leave schemes; and

– compensation committees should be held responsible if executive compensation packages are retrospectively recognized as wrong or excessive.

In the financial sector the following solutions have been proposed:

– the elimination of guaranteed bonuses and golden parachutes (to mitigate the risk of 'pay for failure');

– a cap on cash bonuses and the cancellation of stock options, replacing the latter with restricted shares redeemable over a 10-year period (to avoid the so-called 'short-termism' approach);

– the clawback of payments made to risk takers whose decisions/actions destroyed client assets and shareholder value (to halt the quest for a 'fake alpha'); and

– a serious analysis of sources of profit by focusing on know-how and innovation versus cheap money and excessive risk (interest rates are established by central banks, the cost of the risk should be taken into consideration and internal risk management reinforced).[23]

Some of these proposals are in line with the conclusions that emerged from a survey conducted by MM & K of 375 chairmen and non-executive directors on UK executive pay.* The main messages emerging from the survey were to:

– keep executive compensation simple;

– maintain a longer-term focus;

– introduce mechanisms to assess whether promised performance can be sustained; and

– ensure that performance targets are relevant and consistent with the business plan.

Such messages should not be ignored.

QUESTIONS STILL PENDING

After this storm on executive compensation there are several new challenges facing remuneration committees. In fact, the new legislative rules and the new corporate governance guidelines raise the following issues:

– how should bonus plans that do not pay out be handled;

– how can key talent be retained in a strictly regulated executive pay environment;

– how should the remuneration committee communicate with the key shareholders, i.e. institutional investors; and

– how can executive pay levels be justified to the various stakeholders (mainly to the general public)?

Overall, the most relevant questions still pending are as follows:

● In the future, what will be more critical – shareholder activism or public outrage?

● Is an approach based on self-regulation still reasonable or will government legislation prevail?

● Do institutional investors really want 'say on pay' or do they prefer a *laissez-faire* approach, leaving the problem to governments?

● Ultimately, is the main purpose of corporate governance to protect shareholder value or to guarantee stakeholder interests?

Against this backdrop the European Commission decided to intervene by enacting a third Recommendation concerning the remuneration of directors of listed companies.

THE EUROPEAN COMMISSION'S RECOMMENDATION

The Recommendation (2009/385/CE of 29 April 2009) contains several principles in the following areas:

– variable pay,
– termination indemnities,
– share plans,
– disclosure,
– remuneration committees, and
– shareholders' votes.

We will focus our attention on the most relevant and innovative features of the Recommendation.

Variable Pay

Variable pay should be linked to the long-term performance of the company and must be recognized only when assigned objectives are actually met. These objectives should be established on the basis of both financial and non-financial criteria (such as the improvement of intangible assets).

A significant proportion of variable pay (incentive and/or bonus) should be frozen, to be paid out only after a certain period, such as three to five years, when short-term results could be considered as definitely delivered. The Recommendation proposes that variable pay be reclaimed if paid on the basis of data manifestly misstated.

It has also been suggested that variable pay must have a ceiling (in absolute amount and/or as a percentage of basic pay). With the exception of this proposal (which has been introduced by some countries for the companies that have received public funds), all other proposals seem to be reasonable, although not necessarily easy to introduce from a practical standpoint. Their effective implementation will represent the real challenge for remuneration committees.

* For further information, please see 'A Non-executive Perspective on UK Executive Pay,' by Paul Norris, *B&C International*, June 2009.

Termination Indemnities

The era of the golden parachute is definitely over. The guidelines contained in the Recommendation establish a maximum termination indemnity corresponding to two years' basic pay.

No payment should be made in cases of dismissal due to inadequate performance. In addition, no payment should be recognized in the case of voluntary resignation. The only exception is resignation due to a merger/acquisition or to a change in company strategy.

It is difficult to challenge these sound proposals. However, they should be taken for what they are, just reasonable guidelines. From a practical standpoint, it is still necessary to draw a distinction between:

– a top executive who has spent most of his/her career with the same company and a top executive who has been hired and/or appointed just a few years before;

– a top executive entitled to receive a generous defined benefit pension from a company plan and an executive who is only entitled to a fairly modest statutory pension; and

– a top executive who has enhanced shareholder value before a merger and a top executive who has brought his/her company to the verge of insolvency, before it became an acquisition target following pressure from public authorities.

These differences do matter.

Share Plans

In the case of share plans, most of the proposals made by the Commission are completely in line with good corporate governance practices and, as such, have already been adopted by a number of companies or been made a requirement by some governments.

These proposals specifically concern vesting provisions for share plans. Vesting should not be recognized for at least three years and should be subject to specific performance criteria. Once shares become vested, they should be retained in part until the executive reaches the end of his/her mandate. Furthermore, no share options should be awarded to non-executive directors.

As in the case of variable pay, the most difficult aspect concerns the choice of the performance criteria (particularly as share plans must be linked to long-term performance and the economic and business environments tend to change significantly over time).

The partial retention of shares until the end of the mandate (with a target value corresponding to two years of total cash compensation) appears to be a very reasonable proposal. Another factor that should probably be taken into consideration in determining retention is the number of shares awarded or options exercised.

Disclosure

The Recommendation has increased the level of disclosure by requiring:

– an explanation of the choice of criteria and methods of performance;

– information on the deferral of variable pay and termination indemnities;

– information on vesting and the retention of share-based plans; and

– the explanation of peer group choice.

All these requirements seem perfectly in line with good corporate governance practices.

The relevance of disclosure should not be underestimated. A clear and detailed report of executive remuneration will allow institutional shareholders to exercise proper control and to challenge poor pay practices in the companies in which they have invested.

Remuneration Committees

The Commission has introduced three quite innovative proposals concerning the composition and activity of the remuneration committee.

First of all, the committee must have at least one member with knowledge and experience of executive pay. In my opinion, this proposal requires specific expertise. Otherwise any chief executive or former chief executive sitting on the board as a non-executive director could claim to have experience and knowledge of executive pay. However, if specific expertise is needed, should company boards include a director working for an executive compensation consultancy or a former human resources manager? In my view, it does not make sense to increase further the number of board members just to guarantee a qualified opinion on executive remuneration.

Rather, it would be much more sensible to apply the second proposal made by the Commission properly, which requires the remuneration committee to use an executive compensation consultant different from those already providing consulting and/or outsourcing services for the company and specifically for its management. This issue was analysed in 2007 in US congressional hearings convened by Henry Waxman, the California Democrat, head of the House Committee on Oversight and Government Reform. The Committee found that, during 2006, 179 of the 250 largest publicly traded US companies disclosed hiring at least one of the top six consulting firms to advise them on executive pay. Of those companies, 113, or 63%, paid the same firm to provide other services for the company in 2006, creating the potential for conflicts. The Committee also found that 30 of those companies identified their compensation consultant in Securities and Exchange Commission Filings as 'independent'.[24]

The elimination of the conflict of interest of the consultants advising the remuneration committee could be as effective as the inclusion in the committee of a director with specific expertise in this field. It will also provide the committee with a much larger degree of flexibility (it is relatively easy to change a consultant, much more difficult to replace a board member!).

In my opinion, this proposal should be implemented through a requirement for a specific budget for the remuneration committee so that the consulting fees of its consultant can be paid directly. This budget will guarantee the financial autonomy of the committee *vis-à-vis* the company management.

The third proposal contained in the Recommendation in relation to remuneration committees concerns the correlation between chief executive pay and the pay of staff in the same organization. Basically, the terms of reference for a given chief executive compensation package should not only be external, but also internal.

The Shareholders' Vote

The Recommendation requires institutional shareholders to take a much more active role in executive pay. More specifically, it states that:

> "Shareholders, in particular institutional shareholders, should be encouraged to attend general meetings where appropriate and make considered use of their votes regarding directors' remuneration, while taking into account the principles included in this Recommendation, Recommendation 2004/913/EC and Recommendation 2005/162/EC."

In fact, while in the past institutional shareholders were quite passive *vis-à-vis* the escalation of executive pay, now they tend to be much more proactive, even in countries such as Switzerland where 'say on pay' is not legally required[25]. It is worth noting, however, that in the USA institutional investors have contributed to the inflation in executive pay by automatically approving proposals made in shareholders' meetings[26].

In my view, the only way to really empower shareholders on executive compensation matters is to give them the right to change the remuneration consultant. As has been noted:

> "At the moment, shareholders have a toothless, retrospective, non-binding advisory vote on the remuneration report but if they could insist upon a review or change of remuneration consultants, it would give them real power."[27]

CHANGE OF DIRECTION IN EXECUTIVE PAY

There is no doubt that differentials between the highest-paid executive and the lowest-paid employee in all European companies have been increasing inexorably for the last 20 years.

It is less obvious that the escalation of executive pay has been one of the main causes of the current economic crisis. However, public opinion has made a link between excessive executive pay and the economic crisis. It has also identified several responsible parties: greedy executives, weak remuneration committees, complacent consultants, inadequate regulators and inattentive and inactive shareholders.

I believe that Recommendation 2009/385/CE has properly addressed the most relevant issues concerning chief executives' and directors' remuneration, without indulging in unhealthy populism.

A proper implementation of the principles contained in this Recommendation will not be sufficient to avoid future financial and economic crises, but will probably focus the attention of the public on the management decisions of chief executives rather than on their compensation packages. This perspective will certainly contribute to identifying more quickly the remedies to the crisis, rather than wasting time looking for a scapegoat.

Unfortunately, the very recent rebounding of the financial markets has evidenced a different group of 'bad boys' – bankers in general and traders in particular. The accrual of several billions of dollars, euro and pounds to finance the bonus pool of the traders for their expected 2009 performance has outraged the public in France, the UK and the USA. At the recent G20 Meeting in Pittsburgh pay in the banking and financial services industry was supposed to have top priority on the world leaders' agenda.[28] In fact, as has been concluded:

> "The only significant innovation to emerge from the G20 relates to 'claw-backs' that allow banks to reclaim compensation awarded in earlier years if trading activity later backfires. These existed at some banks, such as Credit Suisse, before the crisis... The other big reform advanced at Pittsburgh – the call for between 40 per cent and 60 per cent of senior bankers' bonuses to be deferred over at least three years – is nothing new."[29]

In any case, in my opinion, this change of perspective – from chief executives' and directors' pay to the compensation package of banking managers below board level, traders and financial specialists – could be both wrong and pointless.

Wrong, because the choice of an incentive system, a reward strategy and the breakdown between fixed and variable pay is basically a business choice, even in the banking and financial sectors. They may be wrong but, in this case, the management should be changed and even pursued in the courts. However, it is not the legislator's role to shape the strategy of a bank. The role of the public authorities is to make sure that banks and other financial institutions do not undertake excessive risks with investors' money and remain solvent in order to guarantee their deposits. However, the public authorities should not exceed this role by implicitly running the banks.

Pointless, because it will be virtually impossible to control the compensation package of thousands of traders, financial specialists and middle managers in the banking and financial industry. Who will be in charge of such control? The Central Bank? The supervisory authority for the financial market? The shareholders?

The experience of the last 20 years shows that public authorities and shareholders (even the powerful institutional ones) have been very poor at controlling the escalation of chief executives' pay, so it is hard to see how they could handle serious control of the incentive schemes of thousands of traders!

For this reason, proper implementation of the Recommendation on chief executives' and directors' remuneration will already represent a significant achievement. Once the pay of top management is properly regulated by the public authorities and controlled by responsible shareholders, chief executives of banks will make sure '*l'intendance suit*', i.e. that employees are rewarded for their achievements rather than for their failures. Ω

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