All Change for Executive Pay

The challenge for remuneration committees is to develop a framework for executive pay, which not only rewards financial performance but also drives a company's long-term goals. ***Criticaleye*** *speaks to remco chairmen to find out whether they are succeeding*

Seemingly lavish rewards for executives with little explanation or context will always make for good headlines. It's up to the chairman of the remuneration committee (remco) to disclose what's happening in a fashion that stakeholders understand, while finding a way to blend salaries with short and long-term incentives which attract and retain the best people, meet regulatory requirements and drive high performance.

Failure to disclose the rationale behind decisions adequately will see institutional investors and proxy agencies push back hard. According to *research from Big Four firm EY*, examples of recent red flags for shareholders include hikes in bonuses despite falling profits, granting Long-Term Incentive Plans (LTIPs) above the normal maximum, which have been justified by 'exceptional circumstances', and, in one instance, the introduction of a new LTIP which increased the maximum award value to 350 per cent of salary.

There is plenty for remco chairs to juggle and scrutinise. **Jeff Harris**, who is Chairman of plastic and fibres supplier Essentra and also Chairman of the Remuneration Committee at Synergy Health, welcomes the improved communication now occurring in ▸

the UK following regulatory reforms. "It's positive because if we understand the objectives of the investors, boards can meet them better and can refer to their wishes in arguing points with company executives," he says.

Mark Shelton, Partner and Head of Executive Compensation and Reward at EY, says: "Remco chairs need to reflect and remind themselves that they're fundamentally there to drive business performance, and that means attracting, retaining and incentivising talent within a landscape of the new regulatory environment for shareholders. Then it's about the public and the politicians."

A similar point is made by **Roger McDowell**, who is Chairman of engineering company Avingtrans and Chairman of the Remuneration Committee at beauty and cosmetics designer Swallowfield: "Absolutely uppermost is development of shareholder value through motivation of management, I mean that is what it is about... But in terms of getting the motivation, there has to be something that is broadly acceptable to all stakeholders."

An ongoing concern about executive pay is that regulatory changes are resulting in a box-ticking approach, which actually serves to inflate reward packages. "There is now a prescriptive way to disclose a number of matters on executive remuneration and that will increase transparency," says **Mark**. "The unintended consequence, though, is it will increase pay because people will look at what's been disclosed and move towards the common standard.

> *"Remco chairs will need to be very sensitive to what's right for the business"*

"To drive business performance, remco chairs will need to be very sensitive to what's right for the business and not be overly led by market practice and also what is now being publically disclosed."

Jeff comments: "The main challenge, as ever, is balancing the 'benchmarked' expectations of executives with the constraints of the investors who are the owners. It's not helped by... the lemming-like rush to the upper quartile by executives."

It's up to remco chairs to take a tougher stance and, where necessary, educate CEOs and senior leadership teams about the new regime for executive pay. The emphasis is firmly on a fixed salary, while short and long-term incentives are linked to company performance that may in turn be related to total shareholder return, cash generation, profitability or earnings per share, among others.

Camilla Rhodes, Non-executive Director and Chairman of the Remuneration Committee at Johnston Press, explains: "As long as the communication between the executive team and the remuneration committee is right, and the talent pool is right for the business strategy, it's a relationship that's certainly manageable. But I don't think the remco chair is ever going to be the best friend of the CEO, nor should they be."

	Change in CEO Pay (2013-2014)		Disclosed Pay Levels	
	Median	**Average**	**Median £000**	**Average £000**
Base	+2.6%	+2.3%	692	737
Total benefits	0.0%	-3.8%	192	324
Annual incentives	+2.5%	+28.5%	549	794
Long-term incentives	-3.1%	+13.0%	1,688	2,173
Total Remuneration	+5.0%	+20.5%	2,662	3,768

Source: EY

ON THE MONEY

Devising acceptable packages is complex. Often the calculations involved leave those who lack expertise in this area baffled – even those who do understand it can be exasperated. **Vanda Murray**, Senior Independent Director at manufacturing company Fenner and Chairman of the Remuneration Committee at software company Microgen, says: "Really, you're looking forward and trying to assess what is stretching the business on a one, two and three-year horizon; how it can change over time and, if it changes dramatically, you'll need to be able to adjust accordingly."

Roger says: "What I always try to do is keep the big picture in mind. I'll have a [long-term scheme] for up to three or five years... or some other form of share-based motivation scheme... If the ▸

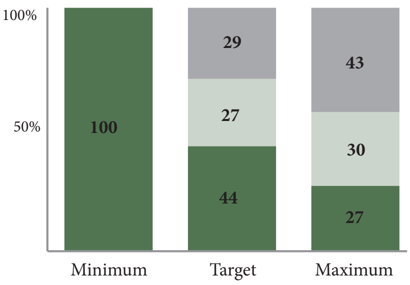
market cap of the business doubles over a three-year timeframe, is that something that the shareholders would be pleased with?

"Would that be the business considerably outperforming its peer group and... be a feather in management's cap? Whatever a great result is for shareholders, it should also deliver a great result for management."

It's a pragmatic approach, whereby remuneration is designed to focus the minds of executives on the future success of the company. If, however, performance proves to be under-par, there ought to be deferred remuneration and 'clawbacks' against variable compensation in place to further protect shareholders.

2013 Disclosures on CEO Policy

2014 Disclosures on CEO Policy (to June)



Fixed (% total)

Short-Term Incentives (% total)

Long-Term Incentives (% total)

Source: EY

Mark says: "Clawbacks in executive remuneration have come to mean clawbacks of awards that are as yet unvested but shouldn't be delivered. This is entirely enforceable as long as it's undelivered.

"What is less likely to be enforceable – and there have certainly been some challenges on it – is clawing back awards that have been paid, taxed, delivered to individuals and potentially even spent."

The position of the remco chair is set to remain controversial. **Leslie Van de Walle**, Chairman of construction industry suppler SIG and Chairman of the Remuneration Committee at diversified investment group DCC, says: "It is a difficult and sensitive area and it is getting worse because... remcos are torn between two objectives which are not always compatible."

It has become a social issue, particularly in the UK – increasingly in the US too – where the sums earned by executives can seem astronomical compared to 'ordinary people'. **Lady Barbara Judge**, Chairman at the UCL Energy Institute, comments: "The real problem is when people make a huge amount of money that they can never spend… and other people work in the company for just as many hours [but receive a lot less]...

"I think that gap is where the problem is; not how much people make at the upper end, but the differential at the lower end."

This can be managed if a remco chair isn't hampered by sclerotic thinking and fully appreciates that times have changed when it comes to transparency. For the immediate future, what's required is a period of calm so companies can devise compensation packages – free from regulatory and political interference – which minimise risks, promote clear disclosure and are rooted in the best interests of businesses.

In addition to this, it helps to bear in mind that it's impossible to keep everyone happy. ■

Featuring Commentary From:

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Essentra

Lady Barbara Judge
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UCL Energy Institute

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Chairman
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Vanda Murray
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