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## Directors' Performance and Remuneration

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### LEARNING OBJECTIVES

- To be aware of the main features of the directors' remuneration debate
  - To know the key elements of directors' remuneration
  - To assess the role of the remuneration committee in setting directors' remuneration
  - To understand the different measures used to link directors' remuneration with performance
  - To know the disclosure requirements for directors' remuneration
  - To be aware of possible ways of evaluating directors
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### The directors' remuneration debate

The last decade has seen considerable shareholder, media, and policy attention given to the issue of directors' remuneration. The debate has tended to focus on four areas: (i) the overall level of directors' remuneration and the role of share options; (ii) the suitability of performance measures linking directors' remuneration with performance; (iii) the role played by the remuneration committee in the setting of directors' remuneration; (iv) the influence that shareholders are able to exercise on directors' remuneration.

The debate about directors' remuneration spans continents and is a topic that is as hotly debated in the USA as it is in the UK. Indeed, the UK's use of share options as long-term incentive devices has been heavily influenced by US practice. Countries that are developing their corporate governance codes are aware of the ongoing issues relating to directors' remuneration and try to address these issues in their own codes. In the UK, the debate was driven in the early years by the remuneration packages of the directors of the newly privatized utilities. The perception that directors were receiving huge remuneration packages – and often, it seemed, with little reward to the shareholders in terms of company performance – further fuelled the interest in this area on both sides of the Atlantic. The level of directors' remuneration continues to

be a worrying trend and as Lee (2002) commented 'the evidence in the US is of many companies having given away 10 per cent, and in some cases as much as 30 per cent, of their equity to executive directors and other staff in just the last five years or so. That is clearly not sustainable into the future: there wouldn't be any companies left in public hands if it were'.

It is interesting to note that a comparison of remuneration pay and incentives of directors in the USA and the UK gives a useful insight. Conyon and Murphy (2000) documented the differences in CEO pay and incentives in both countries for 1997. They found that chief executive officers in the USA earned 45 per cent higher cash compensation and 190 per cent higher total compensation. The implication is that, in the USA, the median CEO received 1.48 per cent of any increase in shareholder wealth compared to 0.25 per cent in the UK. The difference being largely attributable to the extent of the share option schemes in the USA.

The directors' remuneration debate clearly highlights one important aspect of the principal-agent problem discussed at length in Chapter 2. In this context, Conyon and Mallin (1997) highlight that shareholders are viewed as the 'principal' and managers as their 'agents' and that the economics literature, in particular, demonstrates that the compensation received by senior management should be linked to company performance for incentive reasons. Well-designed compensation contracts will help to ensure that the objectives of directors and shareholders are aligned, and so share options and other long-term incentives are a key mechanism by which shareholders try to ensure congruence between directors' and shareholders' objectives.

However, Bebchuk and Fried (2004) highlight that there are significant flaws in pay arrangements, which 'have hurt shareholders both by increasing pay levels and, even more important, by leading to practices that dilute and distort managers' incentives'. More recently the global financial crisis has served to highlight the inequities that exist between executive directors' generous remuneration and the underperformance of the companies that they direct and the concomitant impact on shareholders who may lose vast sums of money, sometimes their life savings, and employees who may find themselves on shorter working weeks, lower incomes, or being made redundant. The International Labour Organization (ILO) 2008 reported that,

the gap in income inequality is also widening – at an increasing pace – between top executives and the average employee. For example, in the United States in 2007, the chief executive officers (CEOs) of the 15 largest companies earned 520 times more than the average worker. This is up from 360 times more in 2003. Similar patterns, though from lower levels of executive pay, have been registered in Australia, Germany, Hong Kong (China), the Netherlands and South Africa.

Furthermore the ILO state that,

developments in global corporate governance have also contributed to perceptions of excessive income inequality. A key development has been the use of so-called 'performance pay systems' for chief executive managers and directors... Importantly, empirical studies show only very moderate, if any, effects of these systems on company performance. Moreover, large country variations exist, with some countries displaying virtually no relation between performance-pay and company profits... Altogether, evidence suggests that developments in executive pay may have been both inequality-enhancing and economically inefficient.

In the context of the global banking crisis, the UK's Turner Review reported in March 2009, and highlighted that executive compensation incentives encouraged 'some executives and traders to take excessive risks'. The Review emphasizes the distinction between 'short-term remuneration for banks which have received taxpayer support which is a legitimate issue of public concern, and one where governments as significant shareholders have crucial roles to play' and 'long-term concerns about the way in which the structure of remuneration can create incentives for inappropriate risk taking'. The Review therefore recommends that risk management considerations are embedded in remuneration policy which of course has implications for the remit of remuneration committees and for the amount of time that non-executive directors may need to give.

The House of Commons Treasury Committee reporting in May 2009 on the *Banking Crisis: Reforming Corporate Governance and Pay in the City* stated

Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking. In too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks.

The Committee also refers to the complacency of the Financial Services Authority (FSA) and states 'The Turner Review downplays the role that remuneration structures played in causing the banking crisis, and does not appear to us to accord a sufficiently high priority to a fundamental reform of the bonus culture'. The Committee urges the FSA not to shy away from using its powers to sanction firms whose activities fall short of good practice. The Committee also encourages the use of deferral or clawback mechanisms to help ensure that bonus payments align the interests of senior staff more closely with those of shareholders. Moreover the Committee believe that links should be strengthened between the remuneration, risk and audit committees, 'given the cross-cutting nature of many issues, including remuneration' and also advocates

that remuneration committees would also benefit from having a wider range of inputs from interested stakeholders – such as employees or their representatives and shareholders. This would open up the decision-making process at an early stage to scrutiny from outside the board, as well as provide greater transparency. It would, additionally, reduce the dependence of committees on remuneration consultants.

Sir David Walker is heading a review of corporate governance in the banking sector which reports later in 2009 and will address many of the issues that have arisen.

As can be seen, there has been much heated debate about flawed remuneration packages which enable large bonuses to be paid even when the company has not met the performance criteria associated with those bonuses; and which also allow departing directors to have golden goodbyes in the form of generous (some would say obscene) payments into their pension pots, or other means of easing their departure from the company. The debate is far from over although one thing is certain which is that the remuneration committees and the shareholders will be looking ever more carefully at the remuneration packages being proposed for executive directors in the future.

## Key elements of directors' remuneration

Directors' remuneration can encompass six elements:

- base salary;
- bonus;
- stock options;
- restricted share plans (stock grants);
- pension;
- benefits (car, healthcare, etc.).

However, most discussions of directors' remuneration will tend to concentrate on the first four elements listed above and this text will also take that approach.

### Base salary

Base salary is received by a director in accordance with the terms of his or her contract. This element is not related either to the performance of the company nor to the performance of the individual director. The amount will be set with due regard to the size of the company, the industry sector, the experience of the individual director, and the level of base salary in similar companies.

### Bonus

An annual bonus may be paid, which is linked to the accounting performance of the firm.

### Stock options

Stock options give directors the right to purchase shares (stock) at a specified exercise price over a specified time period. Directors may also participate in long-term incentive plans (LTIPs). UK share options generally have performance criteria attached, and much discussion is centred around these performance criteria, especially as to whether they are appropriate and demanding enough.

### Restricted share plans (stock grants)

Shares may be awarded with limits on their transferability for a set time (usually a few years), and various performance conditions should be met.

## Role of the remuneration committee

The Combined Code (2008) recommends that 'there should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors' (principle B.2). In practice, this normally results in the appointment of a remuneration committee.

The remuneration committee's role and composition was discussed in Chapter 8. However, in this chapter on directors' performance and remuneration, we consider the effect of remuneration committees on directors' remuneration levels in recent years. Sykes (2002) points out that, although remuneration committees predominantly consist of a majority, or more usually entirely, of non-executive directors, these non-executive directors 'are effectively chosen by, or only with the full agreement of, senior management'. Given that the non-executive directors of one company may be executive directors of another (unrelated) company, they may not be willing to stipulate demanding performance criteria because they may have a self-interest in ensuring that they themselves can go on earning a high salary without unduly demanding performance criteria being set by their own companies' remuneration committees. There is also another aspect, which is that remuneration committees will generally not wish the executive directors to be earning less than their counterparts in other companies, so they will be more inclined to make recommendations that will put the directors into the top or second quartile of executive remuneration levels. It is certainly the case that executive remuneration levels have increased fairly substantially since remuneration committees were introduced which, of course, was not the intended effect. Sykes (2002) makes the pertinent point that all the remuneration packages now so widely criticized as flawed and inappropriate were once approved by an 'independent' remuneration committee.

The performance measures that the remuneration committee decides should be used are therefore central to aligning directors' performance and remuneration in the most appropriate way. Remuneration committees are offered some general guidance by the Combined Code (2008) recommendation that 'levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose' (principle B.1).

In the UK, both the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI) have been involved in the debate about executive remuneration and have issued guidance in this area. The ABI (2002) guidelines on executive remuneration included the recommendations that: remuneration packages should have a balance between fixed and variable pay and between long- and short-term incentives; performance-based remuneration arrangements should be demonstrably clearly aligned with business strategy and objectives; the remuneration committee should have regard to pay and conditions generally in the company, taking into account business size, complexity, and geographical location and should also consider market forces generally; share option schemes should link remuneration to performance and align the long-term interests of management with those of shareholders; performance targets should be disclosed in the Remuneration Report within the bounds of commercial confidentiality considerations.

In December 2005, the ABI issued its *Principles and Guidelines on Remuneration*, which have a two-fold aim of providing 'a practical framework and reference point for both shareholders in reaching voting decisions and for companies in deciding upon remuneration policy'. The Principles and Guidelines emphasize that remuneration (committee) reports should provide a clear and full explanation of remuneration policy, showing a clear link between reward and performance and that 'shareholders believe that the key determinant for assessing remuneration is performance in the creation of shareholder value'.

In December 2007, the ABI made some minor amendments to its *Executive Remuneration – ABI Guidelines on Policies and Practices*. In September 2008, the ABI wrote a letter to the chairmen of the remuneration committees explaining that it did not plan to make any changes at that time to the ABI (2007) guidelines. However, the letter highlighted a number of areas which the ABI wished to draw attention to in the current economic climate. The points raised were

(i) the remuneration policy should be fully explained and justified, particularly when changes are proposed. Members will carefully scrutinise remuneration uplifts, particularly increases in salaries or annual bonus levels; (ii) 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; (iii) shareholders are generally not in favour of additional remuneration being paid in relation to succession or retention, particularly where no performance conditions are attached; (iv) 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.

## Performance measures

Performance criteria will clearly be a key aspect of ensuring that directors' remuneration is perceived as fair and appropriate for the job and in keeping with the results achieved by the directors. Performance criteria may differentiate between three broadly conceived types of measures: (i) market-based measures; (ii) accounts based measures; and (iii) individual based measures. Some potential performance criteria are:

- shareholder return;
- share price (and other market based measures);
- profit-based measures;
- return on capital employed;
- earnings per share;
- individual director performance (in contrast to corporate performance measures).

Sykes (2002) highlights a number of problems with the way in which executive remuneration is determined: (i) management is expected to perform over a short period

of time and this is a clear mismatch with the underlying investor time horizons; (ii) management remuneration is not correlated to corporate performance; (iii) earnings before interest, tax, and amortisation (EBITA) is widely used as a measure of earnings and yet this can encourage companies to gear up (or have high leverage) because the measure will reflect the flow of earnings from high leverage but not the service (interest) charge for that debt. He suggests that the situation would be improved if there were: longer term tenures for corporate management; more truly independent non-executive directors; the cessation of stock options and in their place a generous basic salary and five-year restricted shares (shares that could not be cashed for five years).

The ABI (2002, 2005) guidelines state that total shareholder return relative to an appropriate index or peer group is a generally acceptable performance criterion. The guidelines also favour performance being measured over a period of at least three years to try to ensure sustained improvements in financial performance rather than the emphasis being placed on short-term performance. Share incentive schemes should be available to employees and executive directors but not to non-executive directors (although non-executive directors are encouraged to have shareholdings in the company, possibly by receiving shares in the company, at full market price, as payment of their non-executive director fees).

The ABI published its *Disclosure Guidelines on Socially Responsible Investment* in (2007). Interestingly the guidelines said that the company should state in its remuneration report 'Whether the remuneration committee is able to consider corporate performance on ESG [environmental, social and governance] issues when setting remuneration of executive directors. If the report states that the committee has no such discretion, then a reason should be provided for its absence'. Also 'Whether the remuneration committee has ensured that the incentive structure for senior management does not raise ESG risks by inadvertently motivating irresponsible behaviour'. These are significant recommendations in the bid to have ESG issues recognized and more widely taken into consideration.

Another area that has attracted attention, and which is addressed in joint ABI/NAPF guidance, is the area of 'golden goodbyes'. This is another dimension to the directors' remuneration debate because it is not only ongoing remuneration packages that have attracted adverse comment but also the often seemingly excessive amounts paid to directors who leave a company after failing to meet their targets. Large pay-offs or 'rewards for failure' are seen as inappropriate because such failure may reduce the value of the business and threaten the jobs of employees. Often the departure of underperforming directors triggers a clause in their contract that leads to a large undeserved pay-off, but now some companies are cutting the notice period from one year to, for example, six months where directors fail to meet performance targets over a period of time, so that a non-performing director whose contract is terminated receives six months' salary rather than one year's salary.

The ABI/NAPF guidance emphasizes the importance of ensuring that the design of contracts should not commit companies to payment for failure; the guidance also suggests that phased payments are a useful innovation to include in directors' contracts. A phased payment involves continuing payment to a departing director for the remaining term of the contract but payments cease when the director finds fresh employment. An alternative suggested by the Myners report (2001) is that compensation for loss of office should be fixed as a number of shares in the company (and hence the value of the compensation would be linked to the share price performance of the company).

It does seem that the days of lucrative payments for underperforming directors are drawing to a close. Furthermore, the UK's Department of Trade and Industry issued a consultation document in summer 2003, 'Rewards for Failure: Directors' Remuneration – Contracts, Performance and Severance', which invites comment on ways in which severance pay might be limited by: restricting notice periods to less than one year; capping the level of liquidated damages; using phased payments; limiting severance pay where a company has performed poorly.

In February 2008, the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) issued joint guidance entitled *Best Practice on Executive Contracts and Severance – A Joint Statement by the Association of British Insurers and the National Association of Pension Funds*. The guidance aims to assist boards and their remuneration committees 'with the design and application of contractual obligations for senior executives so that they are appropriately rewarded but are not rewarded for under-performance'. The concluding statement to the guidance succinctly sums up the views of many: 'It is unacceptable that poor performance by senior executives, which detracts from the value of an enterprise and threatens the livelihood of employees, can result in excessive payments to departing directors. Boards have a responsibility to ensure that this does not occur'.

In relation to bonuses, Fattorusso *et al* (2007) point out that

the focus of most criticism has been on salary, severance payments and various long-term incentives (particularly share options). However, executive bonuses have attracted little attention and have been only lightly regulated. This raises important questions. Has lighter regulation been associated with significant levels of rent extraction through bonuses, that is, a weak relation between bonus pay and shareholder returns?

## Remuneration of non-executive directors

The remuneration of non-executive directors is decided by the board, or where required by the articles of association, or the shareholders in general meeting. Non-executive directors should be paid a fee commensurate with the size of the company, and the amount of time that they are expected to devote to their role. Large UK companies would tend to pay in excess of £50,000 (often considerably more) to each non-executive director. The remuneration is generally paid in cash although some advocate remunerating non-executive directors with the company's shares to align their interests with those of the shareholders. However, it has generally been viewed as not being a good idea to remunerate non-executive directors with share options (as opposed to shares) because this may give them a rather unhealthy focus on the short-term share price of the company.

Nonetheless, the International Corporate Governance Network (ICGN) has published in 2009 a draft review of its non-executive director remuneration policy which was first developed in 2006. The draft recommendations include that the retainer/annual fee should be the only form of cash compensation paid to non-executive directors, and that there should not be a separate fee for attendance at board meetings or at committee meetings. However, it is recognized that companies may want to differentiate the fee amount to reflect the differing

workloads of individual non-executive directors, for example, where a non-executive director is also a committee chair. Interestingly, the draft states that, in order to align non-executive director-shareowner interests, non-executive directors may receive stock awards or similar. However any such 'equity-based compensation to non-executive directors should be fully vested on the grant date... a marked difference to the ICGN's policy on executive compensation which calls for performance-based vesting on equity-based awards'.

Importantly, the ICGN also states 'Separate from ownership requirements, the ICGN believes companies should adopt holding requirements for a significant majority of equity-based grants. These policies should require that non-executive directors retain a significant portion of equity grants until at least two years after they are retired from the board'. Such policies would help ensure that interests would remain aligned.

## Disclosure of directors' remuneration

There has been much discussion about how much disclosure there should be of directors' remuneration and how useful detailed disclosures might be. The Greenbury report, issued in the UK in 1995, was established on the initiative of the CBI because of public concern about directors' remuneration. Whilst the work of the Greenbury report focused on the directors of public limited companies, it hoped that both smaller listed companies and unlisted companies would find its recommendations useful.

Central to the Greenbury report recommendations were the strengthening of accountability and enhancing the performance of directors. These two aims were to be achieved by (i) the establishment of remuneration committees comprised of independent non-executive directors who would report fully to the shareholders each year about the company's executive remuneration policy, including full disclosure of the elements in the remuneration of individual directors; and (ii) the adoption of performance measures linking rewards to the performance of both the company and individual directors, so that the interests of directors and shareholders were more closely aligned.

One of the Turnbull Committee recommendations (1999; revised 2005) was that boards should consider whether business objectives and the risk management/control systems of a business are supported by the performance-related reward system in operation in a company.

As part of the accountability/transparency process, the remuneration committee membership should be disclosed in the company's annual report, and the chairman of the remuneration committee should attend the company's annual general meeting to answer any questions that shareholders may have about the directors' remuneration.

The Department of Trade and Industry published its Directors' Remuneration Report Regulations 2002. These regulations require, inter alia, that:

- quoted companies must publish a detailed report on directors' pay as part of their annual reporting cycle. This report must be approved by the board of directors;
- a graph of the company's total shareholder returns over five years, against a comparator group, must be published in the remuneration committee report;

- names of any consultants to the remuneration committee must be disclosed, including whether they were appointed independently, along with the cost of any other services provided to the company;
- companies must hold a shareholder vote on the directors' remuneration report at each general meeting.

The stipulation that companies must hold a shareholder vote on the directors' remuneration report is an interesting one, and something that various shareholder representative groups have campaigned for over a long period of time. However, the vote is an advisory shareholder vote, but it will serve a useful purpose ensuring that the shareholders can vote specifically on directors' remuneration, which has caused so much heated debate for so long. The other provisions will help to strengthen the role of the remuneration committee and enhance both the accountability and transparency of the directors' remuneration-setting process. The disclosures relating to the consultants used by the remuneration committee may also lead to interesting questions relating to any other services they may provide to a company to try to determine their independence.

The ILO (2008) reports

Disclosure practices differ widely across countries. While some countries, including France, the Netherlands, the United Kingdom and the United States require companies to report detailed compensation data in a remuneration report, others like Greece, have no specific requirements . . . companies in such countries as Brazil, Germany, Japan and Mexico frequently report only aggregate data on executive compensation . . . In some countries, executives seem to consider the disclosure of the precise amount of remuneration to be a risk to their personal safety. (Leal and Carvalhal da Silva, 2005)

## International guidance on executive remuneration

### International Corporate Governance Network

The International Corporate Governance Network (ICGN) issued its recommendations on best practice for executive remuneration in 2003. It was hoped that the recommendations would create a consensus amongst both companies and investors around the world about the structure of remuneration packages.

The ICGN recommendations stated that the 'fundamental requirement for executive remuneration reporting is transparency'. This was the starting point: that there should be disclosure of the base salary, short-term and long-term incentives, and any other payments or benefits to each main board director. The remuneration committee should publish statements on the expected outcomes of the remuneration structures, in terms of ratios between base salaries, short-term bonuses, and long-term rewards, making both 'high' and 'low' assumptions as well as the 'central' case. Whilst recognizing that share options are probably here to stay, the ICGN recommendations supported the International Accounting Standards Board (IASB) proposal to expense share options through the profit and loss account.

The remuneration committee report should be presented as a separate voting item at every annual meeting (this would depend on local practice). The ICGN also urged institutional investors to devote more resources to the analysis of remuneration resolutions.

In 2004, the ICGN published statements about the compliance of each of the UK, USA, and Australia with the ICGN's Executive Remuneration Principles. Each of these countries generally complied with the principles, although each had strengths and weaknesses on particular issues.

In 2006, the ICGN approved the updated ICGN Remuneration Guidelines. Three principles underpin the new Guidelines: transparency; accountability; and the performance basis. The Guidelines state that there should also be thought given to the reputational aspects of remuneration.

At present, the ICGN have circulated draft recommendations on non-executive director remuneration (discussed above) but no further guidelines on executive remuneration.

## The European Commission

In April 2009, the European Commission announced new guidelines for directors' remuneration which include, *inter alia*, performance criteria that 'should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long-term value creation'; clawback provisions where variable elements of remuneration were rewarded on misleading data; and termination payments not to be paid where performance had been poor. However, these guidelines are not intended to be binding on member states.

## The Conference Board

In the USA, the Conference Board Commission on Public Trust and Private Enterprise was established to address widespread abuses that led to corporate governance scandals and a resulting lack of confidence in the markets.

One area that the Commission looked at was executive compensation. The Commission reported in 2002 with principles, recommendations, and specific best practice suggestions. The seven principles relate to: the compensation (remuneration) committee and its responsibilities; the importance of performance-based compensation; the role of equity-based incentives; creating a long-term focus; accounting neutrality; shareholders' rights; transparency and disclosure. The principles serve to clarify several areas and identify that the compensation committee, which should be comprised of directors who are free of any relationships with the company and its management, should be primarily responsible for ensuring that there is a fair and appropriate compensation scheme in place. In order to aid them in this role, the compensation committee may appoint outside consultants who should report solely to the committee. Performance-based remuneration incentives should 'support and reinforce the corporation's long-term strategic goals set by the board (for example, cost of capital, return on equity, economic value added, market share, quality goals, compliance goals, environment goals, revenue and profit growth, cost containment, cash management, etc.)'. In relation to the role of equity incentives, such as share options, the compensation committee should ensure that disclosure is made of any costs to shareholders associated with

equity-based compensation such as dilution; the earnings per share after dilution should be shown. Key executives and directors should be encouraged to build up a reasonable shareholding in the corporation and hold that shareholding for the longer term.

The Commission's report is likely to influence policy in many countries, especially those countries that have already followed the US-style remuneration package and adopted share option schemes.

In Spring 2009, the Conference Board announced the establishment of an Executive Compensation Task Force. They state that

The Task Force brings together corporations and investors, and governance, legal, compensation and ethics experts to address one of the most important issues in today's business world. The Conference Board's new Task Force is part of its broader reexamination of the foundations of the current crisis and its impact on global growth and stability as well as institutions, business organizations and markets.

## **Conclusions**

The debate on executive directors' remuneration has rumbled on through the last decade, but with the increase in institutional investor activism and the scandals and subsequent collapses associated with a number of large corporations in the UK, USA, and elsewhere, the focus is well and truly on curtailing excessive and undeserved remuneration packages. The global financial crisis and the collapse of various high profile banks and financial institutions has left the market reeling. There is a lack of public confidence in the boards of banks and disbelief at some of the executive remuneration packages and ad hoc payments that have been made to executive directors. There is now an emphasis on payment for performance in a way that theoretically was present before the global financial crisis but in practice, all too often was not. The remuneration committees, comprised of independent non-executive directors, will come under increased scrutiny as they try to ensure that executive directors' remuneration packages are fairly and appropriately constructed, taking into account long-term objectives. Central to this aim is the use of performance indicators that will incentivize directors but at the same time align their interests with those of shareholders, to the long-term benefit of the company.

### **SUMMARY**

- The debate on executive directors' remuneration has been driven by the view that some directors, and especially those directors in the banking sector, are being overpaid to the detriment of the shareholders, the employees, and the company as a whole. The perception that high rewards have been given without corresponding performance has caused concern, and this area has increasingly become the focus of investor activism and widespread media coverage.
- The components of executive directors' remuneration are base salary, bonuses, stock options, stock grants, pension, and other benefits.

- The remuneration committee, which should be comprised of independent non-executive directors, has a key role to play in ensuring that a fair and appropriate executive remuneration system is in place.
- There are a number of potential performance criteria that may be used to incentivize executive directors. These are market-based measures (such as share price), accounts-based measures (such as earnings per share), and individual director performance measures.
- It is important that there is full disclosure of directors' remuneration and the basis on which it is calculated.
- There seems to be a trend towards convergence internationally in terms of the recommendations for the composition, calculation, and disclosure of executive directors' remuneration.

### **Example: GlaxoSmithKline plc**

*This is an example of a company that has had to reconsider its executive remuneration package in the light of pressure from investors.*

In late 2002, GlaxoSmithKline proposed a remuneration package for its chief executive that was reputedly worth some £11 million. The proposed package would have resulted in a basic salary of over £990,000 and the granting of options exercisable over a five-year period and estimated at being worth just under £9 million.

The proposed package caused widespread concern amongst the company's largest shareholders at a time when there were concerns being expressed over various aspects of the company's strategy. In addition, the performance targets associated with the package were not viewed as being particularly stretching. A number of the company's largest shareholders met with the company's chairman to discuss the matter. After several days of discussion and debate, the company finally agreed to drop the proposed package and to maintain the chief executive's existing remuneration package for another year, whilst considering what revised proposal might be put forward in the future. In late December 2003, GlaxoSmithKline announced new executive remuneration arrangements with: the link between pay and performance strengthened with robust EPS and TSR hurdles; contracts for executive directors reduced from 24 months to 12 months without compensation; remuneration aligned with other global pharmaceutical companies; and the new policy closely aligned with UK shareholder best practice guidelines.

It is noteworthy that at the company's AGM earlier in 2003, GlaxoSmithKline had suffered the ignominy of being the first company to have its remuneration committee report rejected by shareholders as part of a new advisory vote scheme introduced in 2002 under the Department of Trade and Industry's Directors' Remuneration Report Regulations.

GlaxoSmithKline has hit the headlines several times subsequently with its remuneration policy. In 2009, the Chairman of the company's remuneration committee announced that the Chief Executive would receive a significant rise (an increase of £150,000 to £1,000,000) in his cash pay but no stock options. The executive directors will still receive shares based on their performance as it relates to 60 per cent total shareholder returns relative to other large pharmaceutical companies, and 40 per cent relating to cash flow targets. This new policy would seem to be more consistent with tying in to long-term performance targets.

**Example: American International Group (AIG)**

*This is an example of one of the largest American insurers which has received federal government bail out money but has continued to pay retention bonuses to its senior employees.*

The American International Group (AIG) has been kept afloat by more than US170 billion in public money since September 2008. A furore broke out after it was revealed that large bonuses were being paid to executives only a few months after AIG received federal support. The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), a voluntary federation of 56 national and international labor unions and representing 11 million members, was one of the groups astounded at the payouts at a time when thousands are losing their jobs. AFL-CIO were particularly incensed about these payments which 'were in the form of "retention" bonuses to employees of its financial products division, which sold the complex derivatives at the heart of the company's financial troubles... AIG's poor pay practices expose the fallacy of "pay for performance." The potential windfalls for executives were so massive they had nothing to lose by taking on huge risks to create the illusion of profits.'

The CEO, Edward Liddy, asked the senior employees to pay back the bonuses, totalling US165 million, urging them to 'do the right thing'. Many of them have now done so.

More generally, the US government is currently looking into how the oversight of executive compensation might be changed. However it seems that general caps on salary will be unlikely although regulators may intervene if it seems that bonuses might encourage short-term risk at the expense of long-term solvency. The call for 'say-on-pay' legislation whereby shareholders have the right to vote on directors' remuneration has gained momentum in recent years in the US.

**Mini case study: Royal Dutch Shell plc**

*This is an example of a company which has received considerable opposition to its executive remuneration policy, and has suffered a defeat in this regard at the hands of its shareholders.*

Five senior directors of Shell were subject to angry criticism from shareholders when it became known that the remuneration committee's report recommended that they be awarded bonuses amounting to £3.6 million even though the company had failed to meet its performance targets. The CEO of Shell, Jeroen van der Veer, was subject to particular criticism for the proposed bonus to be paid to him of €1.35 million. This meant he would receive a 58 per cent pay increase for 2008.

Shell suffered one of the largest votes against its remuneration report when 59 per cent of the shareholders voted against it at the company's AGM in May 2009. Those voting against the remuneration report included large pro-active institutional investors such as Standard Life and Ontario Teachers' Pension Plan. The institutional investors, therefore, represented a range of countries. It is becoming increasingly clear that the way in which directors' remuneration is calculated is failing in the 'pay for performance' aspect, and there is no doubt that performance criteria will be tightened up in future.

Jeroen van der Veer has been replaced as CEO by Peter Voser, the Chief Financial Officer of Shell. Mr Voser has already set in motion restructuring plans to enable the company to cope with lower oil and gas prices, and also a drive to cut costs in various support functions, whilst at the same time improving performance.

## ■ QUESTIONS

The discussion questions below cover the key learning points of this chapter. Reading of some of the additional reference material will enhance the depth of the students' knowledge and understanding of these areas.

1. What factors have influenced the executive directors' remuneration debate?
2. Why is the area of executive directors' remuneration of such interest to investors, and particularly to institutional investors?
3. What are the main components of executive directors' remuneration packages?
4. Critically discuss the role of the remuneration committee in setting executive directors' remuneration.
5. Critically discuss the performance criteria that may be used in determining executive directors' remuneration.
6. Critically discuss the importance of executive director remuneration disclosure.

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## ■ USEFUL WEBSITES

- [www.abi.org.uk](http://www.abi.org.uk)** The website of the Association of British Insurers has guidelines on executive remuneration issues.
- <http://www.thecorporatelibrary.com>** The website of the Corporate Library has a useful range of articles/references relating to directors' remuneration.
- [www.conference-board.org/](http://www.conference-board.org/)** The Conference Board website gives details of its corporate governance activities and publications.
- <http://www.bis.gov.uk/>** The website of the Department of Trade and Industry contains a range of information including material on aspects of directors' remuneration.
- [www.icgn.org](http://www.icgn.org)** The website of the International Corporate Governance Network contains various reports it has issued in relation to directors' remuneration.
- [www.ilo.org/global/lang-en/index.htm](http://www.ilo.org/global/lang-en/index.htm)** The website of the International Labour Organization (ILO) which is the tripartite UN agency that brings together governments, employers and workers of its member states in common action to promote decent work throughout the world.
- [www.ivis.co.uk](http://www.ivis.co.uk)** The website of Institutional Voting Information Service (IVIS), providers of corporate governance voting research. The service has developed from the low key, proactive, but non-confrontational approach to corporate governance adopted by the ABI.
- [www.napf.co.uk](http://www.napf.co.uk)** The website of the National Association of Pension Funds has guidelines on various corporate governance issues.
- [www.parliament.uk/treascom](http://www.parliament.uk/treascom)** This website has the publications of the Treasury Committee.

### Part Three case study: Royal Bank of Scotland plc

*This case study draws together a number of the issues covered in this section of the book relating to a dominant CEO, the lack of appropriate questioning of strategy by the board, and perceived overly generous executive remuneration packages.*

The Royal Bank of Scotland (RBS) plc hit the headlines when it had to be bailed out by the UK government in 2008 to the tune of £20 billion with the government becoming a 70% per cent shareholder. The government has also underwritten £325 billion of RBS assets in an effort to stabilize the bank. In common with various other well-known financial institutions in the UK, USA, and elsewhere, RBS had been badly affected by the global financial crisis which, ironically, the financial institutions themselves had helped to cause. Following the initial shock that such a well-known name needed to be rescued by public funding, came the angry outcry at the remuneration packages being paid out to top executives, even after the bank had been bailed out.

In 2007, Sir Fred Goodwin, CEO of RBS at that time, received a salary of £1.29 million and a bonus of £2.86 million, a total of £4.15 million. This package was more than the CEO of any of Lloyds TSB, HBOS, or Barclays received. Under Sir Fred's time as CEO, RBS followed two strategic decisions which ultimately contributed to it incurring massive losses of £24 billion in 2008. The first was that goodwill on past acquisitions had to be written down, and the second was losses arising from its expansion into investment banking and toxic assets. The board has been criticized for not standing up to Sir Fred who has been accused of not only going on a seven-year acquisition spree but also paying generous prices for the acquisitions. Sir Fred subsequently left RBS after being given early retirement at the age of 50 but with a pension of over £700,000 per annum which caused even more anger. Despite requests from the government asking him not to take this huge amount, Sir Fred initially remained unmoved and legal enquiries indicated that the terms of the arrangement meant that he could not be forced to pay it back. However the annual pension has now been reduced substantially although anger at Sir Fred remains high.

Needless to say at RBS's annual general meeting, the remuneration report received an 80 per cent vote against it, clearly displaying the institutional shareholders' disapproval.

RBS' corporate governance was criticized as it was perceived as having a dominant CEO combined with a board comprised of directors who had either been on the board for some years and hence might be seen as being rather too 'cosy' with the CEO, or directors who had limited banking experience. Lord Paul Myners has viewed bank boards generally as inadequate, 'The typical bank board resembles a retirement home for the great and the good: there are retired titans of industry, ousted politicians and the occasional member of the voluntary sector. If such a selection, more likely to be found in *Debrett's Peerage* than the City pages, was ever good enough, it is not now'.

Following on from the disastrous financial performance in 2008, and the criticism across the board from angry investors, an angry government, and an angry public, RBS has also now reduced its board size from 16 to 12, the latter including three new non-executive directors who have received UK government approval. Sir Sandy Crombie, CEO of Standard Life, the insurer, became the bank's senior independent director in June 2009. This should greatly strengthen the RBS board.

## ■ FT CLIPPINGS

## BP rebuked for executive pay

By William MacNamara and Kate Mackenzie

Barely half of BP's shareholders backed the oil major's 2008 pay packages at yesterday's annual meeting, in one of the biggest-ever investor rebellions against director remuneration.

According to early polls projected at BP's annual meeting, only 62 per cent of shareholders who voted approved last year's remuneration package for executive and non-executive directors. Factoring in those who abstained from voting, support was 56 per cent.

Some observers say the BP vote reflects investor irritation with standards of governance and performance across corporate Britain, and could herald other protest votes during the current season of annual meetings.

'If you mention executive pay, people just say "no" at the moment,' said Jonathan Rigby, energy analyst at UBS. 'I don't think the executives have done very much wrong to attract the ire of shareholders, unless there's some intricate sense of dissatisfaction around corporate governance'.

Salaries for BP directors this year have been frozen, the group emphasised, at the request of the chairman and chief executive.

Pay last year, it said, was based on last year's performance, when BP made profits of \$25.6bn (£17.2bn) despite a fourth-quarter loss of \$3.9bn.

BP's 2008 remuneration package included a 16 per cent rise in basic salary and bonus for Tony Hayward, chief executive, to £2.5m, and a 16 per cent rise in the basic salary of Peter Sutherland, chairman, to £600,000.

BP's remuneration committee also voted to give executive directors access to 15 per cent of shares awarded under a three-year 'incentive plan' share scheme. But under the scheme's guidelines, which compares BP's total shareholder return over the period to performance of peer companies, no shares should have been allocated.

'The total shareholder return result, by itself, was not a fair reflection of BP's relative underlying performance over the period,' the committee wrote of its decision to award the shares.

All non-executive directors received pay rises, including Sir Tom McKillop, former chairman of Royal Bank of Scotland, who received £95,000. Sir Tom, who quit the BP board two weeks ago, shortly before he could be considered for re-election this year, has become synonymous with the UK financial crisis. Both Sir Tom and Mr Sutherland, who also sat on the RBS board, were vilified by shareholders yesterday.

'What is breathtaking,' one shareholder said, 'is that [Sir Tom], with the full support of the board, was actually planning to stand for re-election. This is a damning indictment of corporate governance. There should be no rewards for failure and Sir Tom McKillop led RBS to a catastrophic, disastrous failure.' Applause broke out.

Mr Sutherland repeatedly told investors that he would not be drawn into a debate on a former non-executive director who was exemplary while at BP. 'His performance here was first class,' Mr Sutherland said.

BP's shares rose 13p to 442 ½p.

## ■ FT CLIPPINGS

## Thumbs down for RBS pay report

By Jane Croft and Andrew Bolger

Royal Bank of Scotland shareholders have overwhelmingly rejected the bank's remuneration report, which includes the £703,000 pension payment to former chief executive Sir Fred Goodwin.

Some 90.42 per cent of votes cast at the annual meeting in Edinburgh rejected the report. UKFI, the government body that controls a 58 per cent stake in RBS, had already said it would vote against. It is the lowest vote in favour of a remuneration report in UK corporate history, according to Manifest, a voting adviser.

Furious shareholders described Sir Fred, who was controversially granted early retirement aged 50 from the stricken bank, as a 'benefits scrounger' and there were loud cheers when one suggested Sir Fred and all the other former directors should 'go to jail' for what they had done to the once proud Scottish institution.

Sir Philip Hampton, the new chairman, told the 600-strong audience he had employed 'more lawyers than you can shake a stick at' to examine whether Sir Fred's pension contract was watertight. He explained later that two City law firms plus legal counsel were scrutinising the terms of Sir Fred's contract and this work should be completed in the next few weeks.

Sir Philip also revealed he had spoken to Sir Fred earlier this week and asked him again whether he was planning to reduce or give some of his pension pot to charity. He said Sir Fred told him he was still considering this.

'We are leaving no stone unturned to see if the contract is completely solid,' Sir Philip said.

'I understand the frustration from shareholders and the public... the terms were designed to be helpful to the business... I agree the outcome looks very strange indeed,' he said.

Friends of Sir Fred say that he has fulfilled all his obligations to the bank and expects RBS to fulfil all obligations to him.

Sir Fred's position on his pension is not thought to have changed following the conversation with Sir Philip this week. Sir Philip said that he was disappointed by the vote but understood that feelings were running high about the pension, which had acted as a 'lightning rod' for dissatisfied investors.

The meeting was remarkably divided. The management wanted to talk about returning RBS to 'stand-alone strength' 'in three to five years and called for an' end to the public flogging' of the bank, but angry shareholders were determined to air their grievances.

Kenneth Barr, one investor, attacked Sir Fred's 'cataclysmic failure' as chief executive. Another, Tony Peterson, said: 'There is something Kafkaesque about this meeting. It looks like an AGM of a living bank but this is a dead bank on a life support machine funded by the taxpayer.'

One shareholder Harold McKeever drew laughter when he read out a piece of doggerel that suggested that the 'Good Ship RBS has run aground on the Goodwin sands.'

Sir Philip said that he was pleased to see that the spirit of William McGonagall, the notoriously bad bard from Dundee, lived on in Scotland.

