

A Challenging Time for the 'Pay for Performance' Model

It is hard to believe that just six months ago executive pay appeared to be moving out of the spotlight. Not any more.

Executive pay is once again subject to the full glare of media scrutiny as politicians, regulators and shareholders all call for changes. While City institutions have rightly attracted most of the attention, the dramatic fall in companies' share prices and lowered profit expectations have led to a number of bodies issuing guidance notes on how companies should structure their pay arrangements in the current environment.

The story to date

The financial sector

The argument that has gained currency in recent months is that reward structures in the financial sector, weighted as they are significantly towards short-term performance and unadjusted for risk, caused excessive short-term risk-taking which ultimately triggered the banking crisis and current wider recession.

In our view, this claim fails to differentiate between the reward structures of investment bankers/broker dealers - where the argument has some validity - and the pay of many of the most senior executives in financial institutions whose packages already tend to have a more balanced structure, consistent with general listed companies.

Given the dizzying speed with which events have unfolded, we have taken the opportunity in this Briefing to reflect on the last few months. We also consider the issues that we anticipate will come to prominence over the next year once the initial furore over executive pay dies down and a more pragmatic, less emotionally-charged, debate can take place.

However, regulators and politicians have managed to entrench in the public consciousness the idea that reform of all financial sector pay packages is necessary to 'put things right' and that some form of regulation is required to achieve this.

As the first step in this process, in February the FSA published its draft Code of practice on remuneration and has followed that up with a Consultation Paper containing specific proposals to implement the Code which would apply to at least the largest banks, building societies and broker dealers (circa 45 firms) from November 2009.

The financial sector (continued)

The key general provision in this Paper is that these firms must “establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management”. A more detailed summary of the ‘evidential provisions’ (i.e. guidance) underlying this general provision is contained at the end of this Briefing, but two key themes are that:

- In order to try to avoid companies over-paying for short-term, potentially unsustainable, performance, the use of longer-term awards and significant amounts of bonus deferral is advocated; and
- The use of risk-adjusted performance conditions such as economic profit is strongly encouraged, as is the use of non-financial measures linked to risk-management.

The first of the above themes will cause less change at the highest level in these financial institutions, as long-term share awards and/or bonus deferral are already incorporated into the most senior executives’ pay packages. However, it is likely that packages for investment bankers/broker dealers will have to change, with (at the very least) more bonus deferral.

The latter theme, requiring greater account to be taken of ‘risk’ in incentive structures, may drive more widespread change across the entire financial sector and potentially across non-financial companies as well.

But how does a company take account of ‘risk’ in its incentives? Deferral of significant portions of large bonus payments (particularly if such payments are subject to clawback) could help to discourage excessive risk-taking. Beyond that, calculation of profit after deducting a cost of debt and equity capital can be used, with bonus payments then determined by performance against pre-set targets or comprising a percentage of the achieved adjusted profit. Also, should not some account be taken of risks such as liquidity risk, reputational risk and ‘people risk’? Clearly, some of these will be more easily measured for bonus purposes than others. That said, setting risk-adjusted incentive targets is no substitute for employing robust operational checks and balances.

The wider listed company environment

The executive pay model in the wider listed company environment is considerably less aggressive than that applying to the average investment banker or broker dealer, having a more balanced mix both between fixed and variable pay and between short-term and long-term pay potential. And even the most ardent sceptic would probably agree that recent company failures in the wider economy have had more to do with lack of credit or a sudden drop-off in customer demand rather than the result of excessive risk-taking on the part of senior management.

Despite these differences to the situation in the financial sector, executive pay has surfaced as an issue across the broader economy. The key trigger for this widening of the executive pay debate has come from major shareholders, smarting from significant share price falls and encouraged by their corporate governance arms and investor representative bodies to seize the opportunity to push back against the ‘pay spiral’ of recent years.

The shareholder reaction has been two-fold:

- A general reluctance to approve any enhanced incentive arrangements in the 2009 AGM season; and
- The publication of new pay guidelines, the most prominent of which to date was produced by RiskMetrics in February. Their guidelines contained more of a focus on quantum than ever before (including a theme of reducing remuneration levels if profitability has reduced and/or share prices have fallen) and counsel against reducing performance targets for future long-term awards (particularly if there is no corresponding reduction in award size). Interestingly, their focus on quantum contrasts with the FSA who explicitly state that they are not specifically interested in levels of remuneration.

More detail on the RiskMetrics guidance is contained at the end of this Briefing.

How have companies reacted?

Publication of this new guidance has left very little time for companies to respond and consider adapting their remuneration arrangements for 2009. As a result, rather than making widespread structural changes (in the form of brand new plans etc.), companies outside of the financial sector are generally only making adjustments to their existing structures with a view to keeping shareholders 'on-side' at this year's AGM, while still attempting to take some account of the new economic reality.

- **Base Salaries:** A clear majority of our clients have frozen directors' salaries in 2009. Where increases are being made, they are generally limited to no more than the increase for the workforce. We have even seen some limited evidence of salary decreases in companies that have experienced very significant share price and/or profit falls. There has been significant shareholder pushback on the relatively limited cases of above inflationary salary increases for 2009 (or in relation to any increase at all where a company's market capitalisation has fallen sharply).
- **Annual Bonus Payments for 2008:** Shareholders have been concerned that typical bonus payouts have approached 80% of the maximum potential in recent years. We anticipate a lower figure for 2008, although not as low as some commentators might anticipate and with significant variation between sectors. In the coming AGM season, this could be an area of potential contention with shareholders, especially in companies where profitability has remained robust but the share price has collapsed.
- **Annual Bonus Structure for 2009:** Setting appropriately challenging profit targets in an environment where absolute profit levels are anticipated to fall has been the key decision for many Remuneration Committees.

This will be an important area where companies and shareholders will need to seek common ground. In our view, it would be wrong for all bonus plans to be 'mothballed' until the economy moves out of recession. Instead, we expect to see reasonably sized bonuses paid over the next year or so at companies who are performing well in difficult circumstances, even if profit levels are lower in absolute terms than

in previous years. However, greater thought than before will need to be given to shareholder sensitivities in terms of controls on base salary levels and the bonus target-setting process.

Indeed, a significant proportion of our clients are applying more testing payment schedules for their annual bonus in 2009 (as a quid pro quo for the anticipated lower absolute profit levels) by adopting one or more of the following: a higher 'start-to-earn' point as a percentage of budget, less of the bonus paid than previously for achieving budget and a greater degree of stretch above budget to trigger the maximum bonus.

In circumstances where the outlook for profitability is significantly lower (or may even be moving to a loss), there is also evidence of companies scaling back bonus potential as a reaction to the lower profit environment.

These moves have been prompted by the RiskMetrics guidance, which suggests that more companies should adopt a 'profit pool' approach to annual bonuses. While this sounds attractive in theory – as bonus quantum would track profit levels – the concept of a profit pool does not necessarily sit well with the capping of bonus opportunity.

- **Long-Term Share Awards in 2009:** Fewer companies than usual are seeking shareholder approval for new share plans at this year's AGMs. The fact that there are very few instances of new one-off 'recovery-style' plans again shows how reticent most companies are at the current time of tabling new pay proposals to their investors. That said, there is still a significant amount of informal consultation with shareholders by companies that are lowering financial targets (such as EPS) for 2009 awards or considering a short-term shift to the use of Total Shareholder Return ('TSR') when setting robust three-year EPS targets is problematic.

The widespread use of EPS and TSR was criticised by the FSA Consultation Paper. Their use represents a compromise between companies and shareholders around the use of measures that are both relatively transparent and linked to creation of shareholder value. Although there could be potential to tweak

How have companies reacted? (continued)

their calculation, we view these measures as still fundamentally sound and appropriate in most cases, with rolling annual grant programmes reducing the likelihood of large one-off gains being delivered that are more down to the market's perception of balance sheet structure (e.g. levels of gearing) than underlying financial performance.

The general trend is to maintain prior year award levels as a percentage of salary, although a significant number of companies are reducing the size of their 2009 annual awards – typically because they are lowering EPS growth targets (in accordance with the RiskMetrics guidance) or where their share price has fallen sharply and dilution is a concern.

The future

We remain at a relatively early stage in this particular chapter of the executive pay story – for example, the finalised FSA proposals and, in all probability, revised guidelines from the ABI will follow in due course. However, pressure for some sort of structural change in executive pay packages is likely to remain a consistent theme for the foreseeable future, with European regulators also increasing their focus on this area.

We can see the merit in having this debate at this time:

- In some roles, particularly within the financial sector, there is clearly now a strong argument for major structural reform of pay arrangements such as greater deferral of bonus payments and the linkage of deferred payments to future performance.
- More generally, all companies will need, once again, to consider how best to link pay with performance, particularly in the context of a likely prolonged recession.

However, we are concerned about the relatively binary nature of the debate currently being conducted in some quarters, in particular the stark contention of some commentators that 'pay for performance' in its current guise is just not working in UK listed companies and that the entire framework of executive pay needs restructuring.

Our view, by contrast, is that there is considerable evidence that the basic pay model is not broken and that 'pay for performance' is working successfully. For example:

- As discussed above, many companies have responded to reduced share prices and/or profits by freezing salary levels for 2009. Some have gone further and reduced bonus potential and the size of long-term share awards for 2009.
- Bonus payments in 2009 are likely to be significantly lower than previous years. In addition, many existing share awards are unlikely to satisfy their performance conditions over the next couple of years and those that do will generally be worth considerably less than when they were granted. With variable pay comprising at least half of a typical senior executive's potential pay package, this will result in a significant reduction in total pay packages in 2009 and 2010.
- Senior executives are generally unable to crystallise the value of their personal shareholdings when their company's share price is doing well because it may send the wrong message on the outlook for that company. This, combined with the fact that executives have received increasingly large proportions of their pay in shares in recent years and have been encouraged/required to build up a large equity stake through share ownership guidelines, means that the significant share price falls of the last few months have led to many executives suffering considerable 'paper losses' along with other shareholders.

When 'pay for performance' works effectively, it is to the clear benefit of shareholders. Talented executives are retained within the business and are encouraged to drive investor value, in return for which they are fairly rewarded.

The future (continued)

However, for 'pay to performance' to operate successfully, there needs to be a reasonable degree of trust between a company and its shareholders. To some extent that trust is currently lacking and its restoration will require companies and executives to demonstrate that they recognise their responsibility to pay 'fairly' in a downturn (e.g. limited, if any, salary increases, reasonable but not excessive bonus payments etc.) and not provide 'rewards for failure'. Could we see a move to six-month service contracts and a more universal embracing of phased compensation payments and bonus clawback?

But, making 'pay for performance' work is not just the responsibility of companies and executives. Assuming companies and executives do act responsibly, shareholders and their representative bodies also need to demonstrate an appreciation of the altered economic paradigm and shape their attitudes accordingly.

Accepting the logic of companies being able to make reasonable payouts to executives in a downturn for good relative performance, while taking account of the fact that lower profits may be generated than before, is part of that process; another part is resisting knee-jerk policy responses and instead developing frameworks that recognise the need for shareholders to be able to operate more flexibility in analysing the specific circumstances of different companies and, therefore, not adopt an overly prescriptive approach when applying their guidelines.

The current media and political frenzy has enhanced the risk of pressure for a fundamental restructuring of executive pay structures that we think would be unnecessary in most cases. However, if companies and executives behave responsibly through the downturn and shareholders maintain a rational outlook, then, in our view, it should still be possible to achieve a sensible outcome.

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APPENDIX

Summary of FSA Consultation Paper

The consultation relates to the application of the FSA's proposals to large banks, building societies and broker dealers and invites discussion on potential extension to other FSA-regulated firms. Key points are:

- Remuneration committees should contain experts on remuneration and risk management, demonstrate engagement in relation to remuneration policies below top management and interact with the risk management function.
- The FSA may ask companies to produce a statement on their remuneration policies, including an assessment of their impact on the company's overall risk profile and employee behaviour.
- Fixed pay should be a sufficient proportion of the total package to permit a "fully flexible bonus policy".
- There should be use of risk-adjusted short-term and long-term performance conditions as well as non-financial measures linked to risk management.
- Any assessment leading to a bonus 'pool' should ideally be based on profit (rather than revenue) and include an adjustment for current and future risk, cost of capital and liquidity.
- Firms should ideally not assess performance solely on the results of a single financial year.
- There should be significant bonus deferral (not less than two-thirds) where bonus is "significant" and the deferred element of the bonus should be linked to future performance of the firm as well as the employee's division or business unit.

Summary of RiskMetrics UK Remuneration Guidance

Key points of the guidance from RiskMetrics are:

- Base salaries: if profitability has reduced, there should be no increase to base salaries in 2009. Any increases should be restricted to inflation or in line with the workforce pay rises generally.
- Bonuses for 2008: if performance conditions have been missed, there should be no discretionary bonuses. Where performance delivers higher awards than are acceptable in the current circumstances, the Remuneration Committee should consider whether the bonus payable should be scaled back.
- Bonuses for 2009: where profits reduce, the amount of money available to pay bonuses should be reduced. Where profit targets are lowered, bonus potential should be reduced or the sliding scale adjusted. There should be detailed retrospective bonus disclosure and a commentary on the risk factors that have been applied.
- Long-term incentive plans: companies should not adjust targets for prior year awards nor re-price share options. For future awards, RiskMetrics encourages companies not to reduce the financial performance conditions. If companies do change their targets, there should be a reduction in the award level and a toughening of the sliding scale.
- Quantum of remuneration: should not increase and there should not be a shift in the balance towards short-term from long-term variable pay.

About Hewitt New Bridge Street

Hewitt New Bridge Street is the UK's leading executive remuneration consultancy and is named adviser in the Director's Remuneration Report of over 35% of FTSE 350 companies. It is part of Hewitt Associates, a global human resources consultancy and outsourcing company, which helps leading organisations around the world anticipate and solve their most complex benefits, talent and related financial challenges. Hewitt has offices in 33 countries and employs approximately 23,000 associates.

If you would like more information on how we can assist you, please visit www.nbsc.co.uk or email hnbs@hewitt.com.