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**On 30th January, MM&K held a dinner for clients, most of whom were Board Chairmen, CEOs or Chairmen of remuneration committees. Over dinner there was discussion about:**

# What percentage should the top team receive?


**Summary**

1. The percentage which the top team should receive depends on many different factors, including the degree of risk and entrepreneurialism which they need to display.
2. There will inevitably be significant changes in remuneration practice. These are likely to include less emphasis on annual bonuses and more on longer-term remuneration.
3. Executive pay has risen to levels which are regarded as excessive.
4. This is partly a matter of perception. People do not understand how difficult it is to do a CEO's job and the value which they contribute.
5. Some banks have become destroyers of value and no longer support small businesses.
6. The private equity corporate model seems to work better in many ways.
7. More tax incentives should be provided for entrepreneurial activity.


**Introduction**

Cliff Weight introduced the subject. His key points were:

1. 20% to 30% is the answer for the private equity ("PE") industry provided returns to shareholders exceed a hurdle (8% to 15%) before any returns to executives accrue.
2. 5% in 10 years used to be the guideline dilution limit of the Association of British Insurers ("ABI"). However, this can now be increased to 10% if stretching performance conditions are attached to awards – ie annual dilution of 1%.
3. In RBS, the IFRS2 accounting charge for directors and key managers in 2010 represented dilution of about 0.2%.
4. This compares with a typical dilution "run rate" of 2% per year in the US, but dilution can be much higher in some industries, such as high-tech and computer software.
5. For smaller quoted companies, a typical chief executive will build up an ownership stake of about 2%. However, this varies according to a host of factors, including sector, stage of company development, degree of entrepreneurialism and debt leverage.
6. Should the percentage be linked to the company's turnover, profits, cash flow or other measures?
    a. the average CEO's total remuneration is about 0.8% of turnover for a £50 million turnover company; and
    b. it is about 0.03% of turnover for a £5 billion turnover company.

**A lively discussion followed. The main points made included the following:**

What percentage and percentage of what?

1. Executive pay is a deal between management and shareholders. We should be determining what split of added value represents a good deal.
2. Dilution should not be an issue if executive reward depends on adding value greater than the amount of dilution. The question should not be what percentage of equity but what percentage of added value.
3. Relative total shareholder return ("TSR") reduces the link between executive reward and value creation, as there can be a payout even if value falls.



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The PE model is not necessarily the answer for a PLC

4. 30% in PE is very rich. 15% is more typical. The key question is how much you need to give to the management to get them interested. They need to be able to see that if they deliver "x", they will receive "y".
5. For PE, 10% of the equity of the company is reasonable if they meet the performance criteria.
6. PLC and PE are like chalk and cheese. In PE, everyone's objectives are aligned. There are no "politics". There is a better corporate governance model – despite some fabulous failures.
7. Incentive plan structures are also very different. The ABI used to be happy with a review every 10 years – now PLC plans are reconsidered every three years and there are new performance criteria for every year.
8. In the past, when LTIPs were introduced it was not expected they would always pay out. They are now seen as a right. But the PE model is very different. Investors understand that it may take a long time for rewards to come. Management buy into a longer term view. Ownership and management are more closely connected - unlike in PLCs.
9. In PE you put your money where your mouth is. PLC directors are not ordinarily required to put their own money at risk.

Bankers

10. Banking used to be a partnership. One's home was at risk. They would have questioned credit default swaps etc. Now this personal risk exposure has gone away. See comment above that ordinarily PLC directors are not required to put their own money at risk.
11. Most people in investment banks have been destroyers of value over time.
12. Investment banking will not be the road to riches in the future. Bonus pots are shrinking and will continue to do so.
13. The crime of the banking industry was to destroy small banking – now corporate banking people don't understand small companies.
14. RBS communication has been appalling. Executives are paid in shares and will make money only if they make a success of turning round the business. But the public see a loss-making enterprise and wonders why pay bonuses are paid at all.

Public perception of executive pay

15. "When canvassing in Southampton, I have found that executive pay is now a massive public issue." Ordinary people do not understand what you are going to do with £6 million. Why can you not get by with half a million? It is felt that nobody has got executives under control.
16. But it is very difficult for a CEO to achieve high performance. Football players get 3 to 4 times what the CEO of a FTSE 100 company earns.
17. But footballers do not make 30,000 of their colleagues redundant.
18. The conspicuous consumption of "billionaire fat cats" is causing a public reaction, echoed in government circles. There is no differentiation perceived between the FTSE 100 and ordinary CEOs.


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19. What is acceptable to normal people? A multiple of average salary for your organisation? Communication about pay by the business community is appalling. People who run FTSE 100 companies are fantastic. People like Terry Leahy have done a wonderful job. But they don't get the message across.
20. We live in a very political world at the moment. People don't understand what a CEO's contribution is. Labour, Liberals and Tories talk about the concept of fairness and we cannot ignore this. The world is changing.
21. General economic conditions are a factor. People are less likely to complain about executives' pay if they can see that their own pay is also increasing. Perceived fairness is an issue when executives' pay is shown to be increasing at a faster rate than other employees' pay.

Possible tax changes

22. The tax system should make a distinction between short and longer-term capital gains – ie a return to the 1960s.
23. The older generation has good pensions and houses. The younger generation will have them taxed away. If they don't have the right assets, it will be very painful.
24. The Government has put in place 10% entrepreneurs' CGT relief. A lot of people want to take advantage of this but we cannot force the banks to support entrepreneurs. They only lend with security. The need to put your house at risk kills off entrepreneurs.
25. That entrepreneurs should be put off by risk-taking is concerning. There should, however, be a balance of risk-taking; not wholly on the banks and not wholly on the entrepreneur.
26. Entrepreneurs' relief is very difficult to get. Should taper down to zero after, say, 3 years. But HMRC hates anything that replaces employment income. Wealthy people are seen as rogues.

Trends in bonus payments

27. One participant thought that bonuses for senior managers are seen as a waste of time – paying somebody today for better performance tomorrow. Having no bonuses avoids the distraction of discussion of targets.
28. English decisions are based on envy. This will lead to salaries only. Bonuses will be under great pressure. Remuneration strategy determined by focus groups and Twitter. We are in nasty territory.
29. The FTSE has been flat for nearly 15 years (at least if dividends are excluded). We've paid CEOs a lot of money over that period but not clawed it back in bad times.
30. Can you get away with paying no annual bonuses – just salary and LTIs? Yes – build up the salaries and give them high LTI potential if they work very hard. Issue them with a different class of shares so they participate in the growth in value.
31. We are moving that way. Bonuses will be historic. There will be base salaries and deferred compensation/LTIs paying out every 3 years. Packages will become simpler.
32. Financial services companies are now paying bonuses almost all in shares – cash bonuses are going out. This will achieve better alignment with shareholders and real "skin in the game".
33. I thought the most interesting observation of the evening was that, for the most senior executives at least, annual bonuses might drop out of the equation, given generous LTIPs and share options.

34. It does feel as if there is change in the air which provides further and continuous challenge to all in the remuneration world.

Conclusions

1. Clearly, there is no straightforward answer for all situations – no one-size-fits-all solution.
2. That a significant proportion of executive remuneration should be in the form of shares and based on the creation of added value is now entrenched in good governance guidelines and principles on executive pay.
3. Much depends on the type of company and its function in society. The PE model has some merit (even in a PLC context) but is not the whole answer for listed companies.
4. Public perception, the balance of risk and transparency (requiring better communication) are key issues for remuneration committees.
5. A better question is how much of the added value should be ceded to executives? To answer this, remuneration committees must consider the drivers of value in the business and the elements of value creation over which executives have control (which might differ from executive to executive).


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