THE REMUNERATION COMMITTEE DINNER

On 31st January 2011, MM&K held a dinner for clients, most of whom were Board Chairmen, CEOs or Chairmen of Remuneration Committees. Over dinner, there was a discussion about:

Risk and Reward

Summary

- **The cultural and business models of different sectors are hugely different. No standard reward model can or should be applied.**
- **Banks are in the business of taking on risk for profit – risk management is therefore central to their thinking, and the alignment of remuneration with good risk management is essential (this is not the case for all financial services firms).**
- **Companies in most other sectors are concerned with mitigating or hedging risk. A link between reward and risk is not seen as important or even relevant, despite the explicit mention in the new Corporate Governance code.**
- **The real preoccupation for boards and remuneration committees should be performance – and developing the right culture to support performance. A strong system of values is the most valuable asset in achieving this.**

Damien Knight (MM&K) introduced the discussion as follows:

1. The new Corporate Governance Code requires boards to determine the nature and extent of significant risk they are willing to take on, and to manage this risk effectively.
2. Schedule A to the Code makes explicit the need for incentive remuneration to be aligned with this risk management, and to use as appropriate non-financial criteria and deferral with claw-back as tools in achieving this alignment.
3. This change to the Code which applies across all sectors is a knock-on from the banking crisis and the international and FSA codes which have been introduced to align better reward and risk management in financial services firms. Despite an early more flexible approach, the FSA has had no choice in the end but to follow the (largely political) requirements of the Capital Requirements Directive 3 from the EU.
4. The FSA code covers two broad areas, the first being improvements to corporate governance processes, all of which are uncontroversial, such as the need for a competent remuneration committee or similar independent body, a requirement for companies to have a policy about risk and remuneration across the organisation, a requirement to disclose this policy and a need to avoid of conflicts of interest in the risk/compliance staff who police the policy. These requirements apply to non-exempt-CAD regulated firms, about 2,500 in total.
5. The second area covers explicit areas of remuneration structure, with three mandated techniques to improve risk alignment (1) adjustment of bonus pools before the event to allow for the risk-adjusted cost of capital, (2) deferral of a large proportion of variable pay (and part payment in shares) to allow clawback if the view of performance changes or (maybe) if future performance falls and (3) the use of non-financial measures to reward or punish appropriate or inappropriate risk behaviours. But these requirements only apply to senior/high paid/high risk players in the largest 500 or so firms, and anyone earning under £500k and less than 30% variable is exempt in any case, although the FSA is encouraging firms to consider using these deferral techniques on a firm-wide basis. The requirements for increased capital are in any case affecting bonus pools independent of the FSA remuneration code.
6. Damien asked – when non-financial companies seek to comply with the risk management requirements of the new Corporate Governance Code, could any of these techniques from the FSA code be of value?

A lively and fascinating discussion ensued. Some of the points made were:

7. One diner questioned whether good corporate governance by itself can prevent inappropriate risk taking. He argued that the most egregious failure was of RBS and ABN Amro. This was a case of the board who paid too much for an acquisition right at the top of the market. And RBS shareholders voted in favour. Indeed, a report, which was undertaken by the PWC (and cost £7.7 million), concluded "nobody did anything wrong".
8. There was much debate about whether the issue of risk was as relevant to remuneration in sectors other than the financial sector.
    - It is the business of banks to take on risk. They leverage their capital and take risks to achieve high returns. This is very different from industrial companies.
    - A number of attenders argued that in many industrial companies it is not necessary to take account of risk in connection with performance related pay. It is the role of non-executives to limit excessive risk taking by executives. Some argued that it is the culture of the organisation that most effectively manages risk (and that identifiable risks should be outsourced via insurance and hedging strategies). Anyone taking on unnecessary risk will find that it is career-limiting. Examples given were the John Lewis Partnership and Tesco, where employees are very aware of risk, but do not have to have it written explicitly into their remuneration strategy.
    - Other examples were quoted such as Railtrack and BP where risk management is a hugely important part of their business. Safety of employees, customers, contractors is crucial, as is the management of regulators and public opinion. BP was cited as an example of a company having very strong risk processes; however, it is evident that these were not executed properly in practice when making decisions about the balance of cost and risk.
    - GEC, when it changed its name to Marconi, was cited as another example where risk was not managed and where the reward system became asymmetric.
    - What perhaps would be more useful for most businesses is a code of values. Non-executive directors should ensure that such a code exists and that the value system in the organisation supports the appropriate management of risk.
    - The FSA guidelines mention the importance of culture and the use of balanced scorecards. However, there's been so much debate about the issues of deferral and subsequent potential non-payment if performance declines that the issue of culture is in danger of being downplayed or overlooked entirely.
9. One diner felt that the themes of the above discussion about remuneration and reward practices were very different from the advice he had received from remuneration consultants in the past (not MM&K, he was quick to add). His experience had been of the consultants delving down into the details of long-term incentive plans, share plans, bonuses, etc without starting from the first point of asking the question "what are we trying to reward?". Paul Norris of MM&K asserted that had he come to MM&K, he would have had a very different experience, because it is the MM&K approach to ask this as the first basic question.
    - Salary and salary progression were highlighted as rewards which can help support and build a culture in the organisation where the long term has more importance.
    - In contrast an over-focus on short-term bonus has allowed employees in financial services to exploit the situation for their own benefit.
    - Now as a result of the new FSA code, employees earning bonuses of over £500,000 will receive only 20% of it (gross) in cash at the time it is awarded, with the rest deferred and/or invested in restricted shares. After the 50% tax and employees' NI has been deducted their net cash receipt will be less than 10%.
10. Remuneration policy should reinforce the corporate culture and assist recognition of what is important to the business.
11. A discussion ensued about the benefit of group/company wide incentives and profit sharing schemes that encourage collaborative action rather than individual performance, for example like the John Lewis Partnership and the Symm Group, a premium refurbishment/construction company. In contrast, individual incentives can encourage individuals to over-focus on the

wrong behaviours (eg see Alfy Kohn's article "Why Incentives Do Not Work" in Harvard Business Review Sep 1993).

12. One attender said that the question he always asks remuneration committees is "Does the CEO want to stay for ever or does he see his role as a stepping stone in his career?" He felt that in too many cases it is the latter and that as a result chief executives often pursue highly risky and dangerous strategies.

13. Deferral of pay should not be an issue with employees who are taking a long-term view. However, in contrast, if there is no long-term commitment from employees there will be an asymmetry of rewards. Remuneration committees should be aware of this.

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