Challenges facing remuneration committees

MM&K Remuneration Dinner 25 January 2016

MM&K regularly hosts dinners for Chairmen, Remuneration Committee Chairs and Chief Executives. For this dinner, the subject of discussion was **challenges facing remuneration committees**.

Summary of discussion

"What is obvious is that the chair of the rem com is becoming a thankless role, with the task of satisfying shareholders, whilst supporting the executive, a very difficult balance."

Introduction by Paul Norris

Paul chose four specific challenges to start the discussion:

- Meeting stakeholder expectations
- Telling the story
- Public perception
- Complexity

Stakeholder expectations

Stakeholders are a wider group than just institutional investors. Managing their expectations is best done by aligning pay with the success of the company as a whole. All stakeholders should be interested in the long-term sustainability of the business even though each group has its own set of interests. The priority is to manage rather than to meet expectations and that goes for the institutional investors as much as for any other group.

Telling the story

The FRC say that the new Strategic Report of a company should present narrative information to "tell their story". The pay element of the story covers how remuneration is aligned with the business, what is expected of executives, what they and the company have achieved and how this achievement is reflected in what they were actually paid. Recent MM&K research into institutional investors' views (carried out on behalf of the Quoted Companies Alliance) shows that investors feel that incentives are not linked as closely as they could be to KPIs and the business plan. Companies should tell the story from the point of view of what works best for their business.

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Public perception

It's an emotional area, with perceptions focused on the absolute amounts of the CEO's pay and the ratio of this to the average employee's pay (the US have just mandated disclosure of this ratio). "Fairness" is a yardstick commonly referred to but in practice fairness has no common definition. Companies should consider fairness to be about the value created by the business and the share of this distributed to the investors, managers and workforce in return for their respective contribution in creating this wealth. Companies should have their own view of what is fair, explain it and stand behind it.

Complexity

A working group of the Investment Association is reporting this spring on the simplification of executive pay: investors are concerned that pay structures are too complex, which is ironic since it was investor guidelines that led to the complexity in the first place. Directors' remuneration does not have to be complex if it is linked to a clear business plan and strategic KPIs – with long-term incentives rewarding the value created and annual bonuses rewarding the executive actions required to deliver that value.

Discussion

Stakeholder expectations

One diner said he felt that investor guidelines are like his golf swing which he keeps adjusting to correct the hook or slice introduced by the last adjustment. In the same way the guidelines keep changing to correct the last mistake and companies keep changing pay to match.

There has been a series of excesses that have triggered a chain of events that control how everyone manages pay and governance. Enron and Worldcom leading to Sarbanes-Oxley which in turn led to new audit committee responsibilities and guidelines; the banking crisis leading to further financial regulation which has led to new remuneration committee responsibilities and restrictions. We are still making changes in 2016 based on the subprime excesses of 2008 and the revenue-hyping excesses of Enron back in 2001.

Large companies' compliance is then driving small companies who feel they have to adopt "best practice" in reporting and remuneration design.

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One participant felt strongly that the key stakeholder is the employee, not the institutional investor. The latter is just a proxy for the beneficial owner of the shares. It is necessary therefore to understand the reality of what your executives need. For example, people with young children need money now – they do not have a time horizon of 10 years.

This was echoed by another participant who described the paradox of a consumer product company where he is a NED. In no time at all, the young founders have grown the company from scratch to where their shareholdings are worth several million pounds. And yet they need cash remuneration and the remuneration committee finds itself debating this as a problem!

One diner observed that, whatever changes companies make to the elements of pay, salary, bonus and long-term incentives, the overall quantum paid out seems to come out the same – ie companies do seem to manage pay to meet employee expectations.

Not in the oil industry. The industry implosion is having a serious impact on executive pay. The 70% drop in the price of oil is not the fault of executives in oil companies and they hedged as far as possible. Oil companies generally have to take the market price of oil. Shareholders have seen major fall in the value of their holdings in these companies and they expect executive to share their pain. But at the same time they still want the executives to manage things – so there has to be a balance in cutting pay.

It is always the same if a business is going badly – there is a lot more work but smaller bonuses!

One participant suggested that the solution is to allow a higher level of discretion to remuneration committees in deciding bonuses. But, of course, this is strongly opposed by most institutional investors.

It can also be resisted by the executives, who often do not trust the remuneration committee to apply discretion fairly.

Investors say they recognise that there is a balance to be struck between rewarding the executives for the actions they take and sharing in shareholder success or failure. But in their minds the balance is weighted strongly toward the share in success. Basically investors want symmetry in reward – if executives do well in good times they should do badly in bad times.

North American companies do not care what ISS (the proxy advisors) say – they do what is best for the company. But the US model has too much largesse. US boards are a softer touch, and often combining the company chairman/CEO role adds to this. The US system is rigged against the investor.

Why, asked one participant, is the Dow Jones index doing better that the FTSE 100 index?

Telling the story

One participant said they sit the CEO down in front of the rem com each year to discuss the story:

- The challenges facing the company
- What management is tasked with achieving
- What rewards executives can expect given different outcomes

This makes telling the story to shareholders easier at the end of the year as well as making the remuneration more effective.

There is often a mismatch between the numbers and what people did in practice.

It was suggested that remuneration committees should focus their attention on the areas of the business where value is created. But the majority of participants who spoke on this issue agreed that it is for the CEO to decide how remuneration should work below the top team. The board should manage this through the budgeting process, not by direct involvement.

Complexity

It's simpler in Canada. You just have a salary, and bonus (up to 100% salary) and share options. Of course some retail investors will complain that share options give a free share of the upside when they, as investors, have had to put their own money in. But it's a simpler system. Share options are easy to understand.

On the other hand, it is usually impossible to work out how an LTIP [ie performance shares] will eventually pay out. An LTIP is a camel designed by a committee. LTIPs do not motivate anyone.

A guest with several chair and NED appointments said he always argues for absolute total shareholder return as a measure rather than relative shareholder return. It is the institutional shareholders who want relative shareholder return, because that is how the individual fund managers' performance is measured. Chairs of remuneration committee should just say no.

There are so many problems with relative TSR benchmarks. The Oil and Gas industry is facing a major problem with companies going out of business and the effect on the survivor benchmark. Normally these companies are taken out of the benchmark, but this is wrong. They should be left in at a zero share price.

Public perception

Public perception of differentials will depend on the industry. A participant quoted the experience of his oil company which published the CEO pay ratio. The company employs many highly paid geophysicists and was praised by an Aberdeen journal for having such a low ratio! Another participant agreed, saying some of the lowest ratios are in investment banks.

Other challenges facing the remuneration committee

There is increasing pressure on the remuneration committee from the executives "we can get another rem com chair tomorrow!" they'll say. The risky job used to be the audit committee chair but now it's the rem com chair. Everyone wants more transparency. The rem com is in the line of fire.

The remuneration committee may have become more important as executive pay has become a higher proportion of companies' costs.

There is also pressure from the company chairman. Often an alliance forms between the chairman and the CEO and the rem com chair becomes isolated (cf Barclays Bank and the Bob Diamond saga).

But often the rem com doesn't have enough backbone to do what's right for the company in the face of shareholder resistance. They are frightened of being criticised.

It's more straightforward in private equity owned companies, where managers are substantial shareholders.

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