IS THE REM COM ROLE POSSIBLE?

MM&K Remuneration Dinner - 9 September 2013

On 9 September 2013, MM&K held a dinner for Chairmen, Remuneration Committee Chairs and Chief Executives. The subject for discussion over dinner was the complexity of the remuneration committee role.

Summary

Dinner guests generally agreed that the remuneration committee role was very challenging, pay should be linked to strategy and the business needs, external inputs should not be prioritised but a certain amount of box ticking, by complying with certain shareholders preferences, was sensible to avoid unnecessary conflict. Benchmarking was a concern and although an essential tool, it needed careful interpretation to avoid bias.

Introduction

Cliff Weight introduced the subject. His key points were as follows.

The EU, UK Government, BIS, FRC, CBI, IOD, QCA, ISS, ABI, NAPF, leading UK fund managers, hedge funds, NOMADs, shareholders, employees and their representatives, TUC, consultants, lawyers, press, other media and academics all have views on directors' remuneration. The sheer volume of guidelines about what constitutes best practice has risen sharply.

Remuneration committees should be wary of consultants who try to push their latest "fad", as their goal may be to sell more consulting services, rather than to act in the best long term interests of the client companies. However, (good, independent) consultants are well placed to input on what should be prioritised

Of most importance is the input from management. They know the organisation best. But they are conflicted.

Which shareholders and institutions should you listen to, if any? ABI and NAPF represent members' views: they are therefore behind the curve. Hermes/USS and others published a recent paper which is good but has got little traction. Or perhaps one could just look at largest FTSE 100 companies and follow these bellwethers?

Remuneration committees have a difficult challenge to manage all of the above.

Cliff argued that the overarching objectives of motivation, retention and attraction of high-performing executives should be what drive remuneration committee decisions; too much attention to external noise detracts from the key goals; however, they should take guidance on what is crucial to follow.

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

1. CEO tenure is short. Median is 4 years, but 25% serve 8 years or more. Some of the short service is because the CEO is hired to do a short-term job. For others, it is a case of failing or moving on to better things. Pay needs to reflect the CEO's likely time in the job.
2. Some companies and industries need long service CEOs to really build and grow the company and shareholder value. Others need a turnaround or CEO who is good at change. Pay needs to reflect this. The steady as she goes pay strategy with annual grants of LTIs may be best for some FTSE 100 companies, but it won't work for all companies.
3. Companies should consider freezing the CEO salary or simply indexing it to inflation or the average employee increase, if lower. This will avoid the need for annual negotiations on the CEO's salary increase, which are inherently inflationary.
4. Should remuneration committees get involved in remuneration issues further down the company? There was some disagreement on whether this should be their remit. The general feeling was that this was more the role of the board and the chairman of the board, with the remuneration committee concentrating on the executive directors. Involvement in wider remuneration policy is tied closely to succession planning which is a board issue. Succession planning is not so much a question of having a replacement identified for each position (which in a smaller company is not practicable anyway) but whether the company is building sufficient talent and the right management culture generally. One company chairman at the dinner said that his conversations with the chief executive were less about the top team and more about the levels below, where the individuals are less known to the board.
5. Smaller companies cannot afford extra people to provide succession to the CEO, but this should not be an excuse not to do regular assessment of the executives' talent and their potential for succession.

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

6. Tax-effective pay has a much lower priority than in the past. HMRC is keen to reduce/stop tax avoidance plans and legislation has narrowed the scope for tax planning. Nevertheless, there are some legitimate tax planning opportunities and these should be considered (eg EMI plans, pensions, CSOPs, SIPs, SAYE plans, JSOPs and growth shares. AIM shares are exempt from inheritance tax.) It is no longer the case that tax should drive remuneration decisions.
7. Private Equity (PE) has huge tax breaks for the use of sweat equity for executives and tax deductibility of highly leveraged debt. Their corporate governance is also much simpler, more direct and often better.
8. A question was asked as to why listed companies cannot replicate the PE remuneration model. Nigel Mills described the PE model as one in which the key management team at the time of the PE investment are told what their salaries will be (sometimes with annual inflationary increases), what their annual bonus will be based on (if any) and what their equity incentive will be. This is a one-off equity plan which typically only pays out on exit. Given the large majority of listed PLCs do not have an exit as a key strategic corporate goal, it is just not possible to replicate this part of the model.
9. Often, it is not the CEO who creates the patents. You need to incentivise/ reward the white coats too.
10. There was an interesting discussion on teamwork and internal relativities. In some organisations, the delivery of growth in shareholder value may be to a large part down to just a very few executives (eg an acquisition strategy may be down to the CEO, FD and the implementation /integration executive; a turnaround strategy may be driven very strongly be a new CEO and a few key lieutenants who change culture).
11. However in other companies the need for teamwork is crucial and large (unjustifiable) differentials between the CEO and others will destroy co-operation and cohesion. Companies should review the differentials in pay (at target and maximum) for the top 3 or 4 levels of the organisation and check if this matches the desired culture.
12. The skills of the Remuneration Committee Chairman have changed. A good one now has to be a politician, emollient[1] with shareholders, able to write a nice letter, a good communicator and able to get support. Remuneration committees want to act responsibly and make a judgement about pay in the interest of the company. But this judgement is being killed by all the rules. As a remuneration committee member you are torn between backing your judgment and backing your reputation.
13. In the experience of most diners, shareholders are not averse to big payouts for good performance. The corollary of this is that companies need to work harder at avoiding large payouts for failure, eg when exiting directors. A regular review of contractual terms is essential. It is possible (though not easy) to agree to reduce potential entitlements in contracts. The new voting and disclosure rules make it essential for Remuneration Committees to address this.
14. Damien Knight said that many Remuneration Committees are created by corporate governance rules and not the business needs. Different shareholders want different things in remuneration policy and even within shareholder organisations the fund managers and the compliance people are looking for different things. Do the analysts get involved? Not in MM&K's experience. Most shareholders are not in it for the long term. But shareholders are not against pay for success. They just have different views of what success is.
15. Nigel Mills highlighted the need for benchmarking and that often the executive team thought they should be compared with larger companies. There was general concern about the "evils" of benchmarking and its complexity. Very few companies benchmarked themselves at lower than the median and so the process was inflationary. The need for reviewing performance benchmarks as well as remuneration levels was stressed. (This will become more evident with the new 10 year reporting of CEO pay and performance). Market cap was felt to be a poor means of comparison as it failed to reflect the complexity of the management task.
16. Companies flow over the years from good times to bad times. Too often, benchmarking fails to reflect this and over focuses on the latest position. Companies' strategy and consequently remuneration needs to recognise this flow.
17. There is confusion about performance in terms of inputs and outputs, about what is controllable by management and what is extraneous. Many shareholders want absolute shareholder returns (share price increases), others want relative TSR. Some recognise the importance of milestones, KPIs and sustainability measures. Private Equity remuneration focuses on basic salaries, modest or nil bonuses and large potential rewards through equity (ie absolute increases in share price), whilst monitoring performance tightly and this has proved to create successful cultures. In contrast, the performance metrics and desired cultures of some quoted companies are less clear.
18. Cliff summed up that although there is too much "stuff", much of it is a necessary evil of being quoted and Remuneration Committee scan navigate their way through this soup (a good metaphor to match the excellent dinner fare), ticking the boxes where this is not too onerous. Shareholders and their representatives have such a wide range of preferences and guidelines (often at odds with each other) that they cannot all be satisfied, so Remuneration Committees should not be afraid to do what is right for the company and then explain their approach. There had also been very good debates about performance metrics and succession planning.

Note prepared by Cliff Weight and Damien Knight

[1] having the power of softening or relaxing, as a medicinal substance; soothing