# Executive decisions

Executive remuneration is in better shape now than before the crisis, but the opportunity to make lasting fundamental changes has been missed, say **Cliff Weight** and **Damien Knight.**

The new UK Corporate Governance Code rightly says that companies should be managed for the long-term. However, this will only be achieved if top executives have effective incentives that are truly long-term in focus, as well as a major personal investment in their company until such time as they retire or leave. The deferral of large parts of variable remuneration by the banking sector has been a significant step forward; but other changes there and elsewhere have reinforced the '1-to-3 year' model of performance measurement and remuneration which was exposed in the crisis.

## Risk

The financial crisis destroyed some $2 trillion of shareholder value leading to a hue and cry for retribution, and regulation and remuneration. President Obama cited greed, short-termism and opportunism as the principal causes. In response, the Financial Stability Board of the G20 created new guidelines on bankers' pay that are enshrined in European legislation. Implementation in the UK is via the Financial Service Authority (FSA) Remuneration Code, much of which is concerned with remuneration governance and general policy, with an eye to risk management. In larger banks and other credit institutions, top management and others with a significant risk-impact face rules that constrain the design of their pay packages:

- 50 per cent of variable remuneration has to be paid in retained shares.
- 40 per cent of variable remuneration (60 per cent for directors) has to be deferred over three years, with clawback if performance turns out to have been exaggerated.
- Severe restrictions on guaranteed bonuses for joiners, and on severance payments for poor-performing leavers.
- Significant use of non-financial measures in bonuses.

Despite a popular belief that nothing has changed in bankers' pay, these rules, coupled with recent tax changes, mean that it feels very different for bankers. In the old days in many financial firms a £1 million bonus yielded £600,000 net cash at the end of the year. Now a £1 million bonus might yield only 40 per cent maximum in year one. At the new tax rates that's only £192,000 net pay, with the rest phased over three years. We should not feel too sorry for these bankers – many have had years of high bonuses squirreled away in offshore employee benefit trusts, so as to defer or avoid UK taxation. Those needing cash had access to loans. Bankers' cash flow was also helped by substantial salary increases. Investment bank staff such as dealers, who might previously have been

on £150,000 salaries saw their salaries double to £300,000 or more, ostensibly to comply with an FSA edict to make the package less highly geared.

Following direct and indirect Government support to the sector, most banks' income has improved and many have used their rediscovered prosperity to pay large bonuses, albeit to fewer people. Despite this, the UK banks are concerned that the FSA has been more rigorous in implementing the G20 rules than regulators elsewhere, and some are seriously considering changing location.

There will only be an end to banking pay excesses if a way can be found to change the existing 'ransom' model – where a few talented managers and dealers exploit their position with investment banks, who exploit their position with commercial and retail banks, who exploit their monopolistic position with the rest of us.

## Other sectors

In contrast, across non-financial sectors, the financial crisis reduced demand, increased the cost and availability of debt funding, and led to reduced profits. Alignment of remuneration to good risk management was the last thing on the minds of most of these companies. Commonly, salaries were frozen and bonuses reduced. The priority for most companies has been surviving while trying to retain their best people in order to take advantage of the recovery when it eventually arrives.

Many companies had variable pay programmes – these were well-placed to help companies respond to the crisis, by rewarding the perceived business priorities as at each stage of the crisis. It is notable, however, that the changes imposed on banks and credit institutions are now being seen by institutional shareholders and corporate governance commentators as representing 'best practice' for other industries as well. In our view companies need to consider very carefully the relevance of these measures to their particular sector, and consider in particular the negative effects they could have on motivation and performance.

> The changes imposed on banks are now 'best practice' for other sectors.

On top of the lingering direct effects of the crisis, changes in remuneration practice have been taking place against a background of fundamental changes in income tax rules. These changes are largely a consequence of the credit crisis, as successive governments have sought to fill the fiscal gap in ways that get popular support. These changes include:

- the 'temporary' increase in personal taxes to 52 per cent including National Insurance contributions;
- tightening up 'disguised remuneration';
- the tapering out of pensions tax relief and personal allowances for high income earners; and
- the dramatic reduction in the annual allowance for tax-privileged pension saving.

From April 2011, these changes will reduce the cost of pensions tax relief by about £4 billion per annum. Shareholders have insisted that executives are not compensated for these additional tax burdens.

Defined benefit plans continue to fall away. A few older chief executives still have defined benefit pension promises, but most internal promotions to board roles and new hires have a defined contribution plan. In future the norm will be to have a tax-effective pension contribution up to the annual allowance, and then a cash 'pension' allowance on top of this.

Defined benefit plans were very effective at retaining and rewarding high performers who gave long service via salary increases, but which had a disproportionate knock-on pension benefits. New ways to reward such executives may need to be developed.

## Other trends

### Swap of long-term incentive into bonus

Deferred bonus plans are now commonplace. Over 50 per cent of FTSE 100 companies have such plans, up from virtually none ten years ago. These typically require deferral of 30–50 per cent of the bonus into shares for a period of three years. Universally, the introduction of deferred bonus plans has been accompanied by an increase in bonus opportunity. Often this has happened alongside a reduction in long-term incentive plans (LTIP) grants, and there is good evidence that companies have been swapping LTIP grants for deferred bonuses as a more predictable way of delivering share participation to executives. However, there has been some sleight of hand here. Successive Association of British Insurers guidelines clearly stated that LTIP and share option 'performancing' (i.e. awarding shares in the future based on performance at the time of granting) at the point of grant is not considered a suitable alternative to measurement over a vesting period of at least three years. And yet a deferred bonus plan, introduced alongside increased bonus opportunity, is effectively an LTIP performanced at grant.

### Use of multiple measures

FTSE 100 companies have increasingly used multiple measures (e.g. scorecards that record multiple targets that must be met) for their bonus plans. Two-thirds of companies have four or more measures, which contrasts with only a quarter of mid-cap 250 companies. This change has increased the chances of getting at least some payout and, despite the credit crisis, the volatility of bonus payments in the FTSE 100 has reduced. Bonuses are a better bet for executives, since they stand a greater chance of being paid out – the benefit to shareholders is more questionable. The FTSE 100 has led on these changes and the mid-cap 250 is catching up.

So where do all these changes get us? The corporate governance machinery in the UK is congratulating itself on reducing the risk in remuneration in banking and spreading best practice lessons to other sectors. But we at MM&K think there are inherent faults in the emerging model and a real opportunity for change is being missed.

Remuneration committees, under pressure from all sides, are becoming increasingly conservative. As a result, they often look outside for 'best practice' rather than designing tailored remuneration plans which drive value and performance. The 'best practice' model that has emerged is horrendously short-term. The timescale for incentive measurement for bonuses and LTIPs is one to three years. The use of deferred bonus plans has further shortened the timescale of performance measurement. This reflects the systematic short-termism amongst most investors as well as the media. Chief executives are expected to 'do something' to get results in the short-term. Share options are now sadly neglected, despite the fact they potentially create an interest in the share price for up to ten years.

Hopefully Vince Cable's consultation on long-termism in business in the UK can help to reverse this trend and help persuade companies that the high short-term gains, though more lucrative, are not as rewarding as a well-thought-out remuneration programme that tie more moderate gains to long-term success. ■

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