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On 26 January 2009, 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:

Remuneration Lessons from the Credit Crunch

Summary of Discussion

1. This is a time of change. Despite the recession, the probable 3 million unemployed and the credit crunch, companies still need to motivate, incentivise and reward their executives.

2. Three year relative TSR plans do not work. Everyone agreed. See point 14 for reasons.

3. Linking pay to strategic performance measured over fixed periods of more than 3 years has worked well for a number of companies. The process involved first getting agreement on the strategy for the next three or four years and then agreeing the key performance measures and targets. Executives are awarded contingent shares linked to the achievement of the long term targets. They would then not receive another long term incentive award until the end of the performance period. Everyone is clear about the long term targets and all worked towards them.

4. Those present acknowledged that such a plan was simple, easy to understand and motivational.

5. However, the diners also noted that such a plan would not comply with corporate governance guidelines which favour three year relative TSR plans (see Combined Code Schedule A: provisions on the design of performance-related remuneration, provision 4) that are phased rather than awarded in one block (provision 5).

6. The threat from private equity, in terms of poaching key executives and the consequent upward pressure on pay in order to retain them, has disappeared. This has been one factor driving up CEO pay by over 16% p.a. for the past 10 years. Now that the bubble has burst it is unclear if market forces will lead to reductions in CEO pay.

7. Within (some) private equity portfolio companies, there are massively disillusioned management teams.

8. Notwithstanding the current problems in private equity (due to over-leveraging and consequent debt covenant issues) the remuneration in portfolio companies provides examples from which quoted plcs could learn. The approach of allocating a percentage of the equity to management in one block rather than phased each year provides a clear, simple and easily understood incentive.

9. The defeat of the remuneration resolution by the shareholders of Bellway has sent a bad message, i.e. that shareholders are unhappy about managers being given bonuses and rewards for doing a good job in very difficult circumstances. Bellway shareholders voted against the level of bonuses paid but should have voted down the base salary increase, which were not contested. Those present asked how can you incentivise and motivate managers in such circumstances?

10. One non-executive advocated that non-executives should volunteer to waive part of their fees, as this made it easier to be tough on management when it came to dealing with their salary and bonus reviews.

11. Most companies were planning salary freezes and expected bonuses to be much reduced. The contrast with senior civil servants on incremental scales, who would receive the 2% Government limit plus an increment, was noted. Many present felt that such civil servants are completely out of touch with what is happening in the real economy.

12. Quarterly reporting is a disaster and should be avoided at all costs. It creates the wrong behaviour and focuses management on managing (manipulating?) results to meet analysts' expectations. Businesses need to be managed for the long term.

13. There needs to be a dialogue with institutions and building of trust. Institutions believe in relative TSR and they do not trust management in respect of remuneration issues.

14. Relative TSR LTIP performance conditions encourage excessive risk, fast growth strategies and asymmetric reward. In particular:
    a. TSR measured relative to comparator companies over a 3 year period creates bad incentives. “It is nonsense” said one diner, “terrible” said another, and another said “only the Finance Director understands how it works.”
    b. No payout for less than median performance, 25% or so for median and 100% payout for Q3 is asymmetric and encourages risk taking. There is no give back if the company underperforms. 10 years of median performance produces much lower reward than 5 top quartiles and 5 bottom quartiles.
    c. The best way to beat the comparators depends on the business cycle. In a bull market you need to be more highly geared.

15. There is enormous pressure to agree to use relative TSR. Non-executives suffer this pressure and so tend to follow the easier route and adopt the standard approach.

16. The politicians will drive change in bankers’ remuneration. President Obama’s Inauguration Speech spoke of “greed and irresponsibility on the part of some” and on 8th January 2009 he said “government support for any company is an extraordinary action that must come with significant restrictions on the firms that receive support.” On 26 January 2009, Prime Minister Gordon Brown listed the international reforms he said were needed, including, “reforming bankers' pay and rewards to encourage responsible, long-term risk-taking rather than quick profit.” On 13 October 2008 Hector Sants, CEO, FSA wrote “inappropriate remuneration schemes may have contributed to the current crisis”.

17. Companies should pay incentives later (partly in shares and partly in cash). Deferred pay is a handcuff. It helps to retain the best people and makes it more expensive for others to poach your stars. It is difficult to claw back bonuses. But if profits subsequently decline then companies can opt not to pay out deferred bonuses. Business with long cycles (e.g. banking, property) may need to hold back bonus pay for many years.

18. However, the tax system favours cash payouts which receive tax deductibility for the year they are accrued, if they are paid out within 3 months of the year end. Deferred pay only receives tax deductibility on a matching basis, i.e. when individuals receive the benefit and have their tax liability. Thus accounting profits after tax are higher in companies that pay out bonuses within three months of their yearend rather than deferring them. This anomaly should be reviewed by the Government.

19. Companies should identify their business strategy, which people are needed to deliver it (including any new hires), how much pay is needed to keep them, how much extra they should get if they deliver the strategy and how much extra above that if they exceed the strategic goals.

20. Copycat remuneration plans that tick corporate governance boxes do not add value. Remuneration Committees need to consider carefully what is needed.

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