THE REMUNERATION COMMITTEE DINNER

On 27th September 2010, 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:

Setting bonus targets is difficult

Summary

- **Variable pay doesn't necessary drive good performance**
- **Shareholders want variable pay to ensure high pay is justified**
- **Companies have to hire and retain talent, and can be outbid**
- **Shareholders want relative performance measures, to reflect underlying performance. But relative measures are not easy to operate and managers want to understand their measures.**
- **Bonus targets should reflect business priorities at the time.**
- **Cash is the source of value. Bonus/variable pay should be linked to cash returns in excess of the cost of capital measures as a percentage of the value created.**

Cliff Weight (MM&K) introduced the discussion. He said:

1. Increased bonus opportunities (CEOs of larger companies now earn up to 300% of salary) mean that setting effective bonus targets has become even more important – but it is difficult. Executives want targets that they feel are achievable, motivational and offer a good chance of a good payout. Shareholders want value for money and are increasingly questioning whether targets have been set at too low a level. Remuneration Committees have to manage this contradiction.
2. Why is it so difficult? The first problem is that companies are not always sure of its objectives in running a bonus plan. Is it:
   a. To keep executives happy and motivated?
   b. To link pay to performance?
   c. Profit sharing (like partnerships and investment banking) where x% of profits go into the bonus pool and executives expect their pay to go up or down with the cycle?
   d. To motivate managers to do things that are under their control and to reward them for what they do?
   e. Or do companies end up paying managers for being good budget negotiators?

3. The standard 'boilerplate' remuneration goals are to attract, retain and motivate. Perhaps a better way is to have the number 1 goal to motivate, 2 retain and 3 attract.
4. To motivate, the executives must feel that the targets are achievable. Executives want easy targets, and many will choose an approach to pay to maximise their payout. There are lots of behavioural and psychological issues at play here. Board dynamics are crucial, as is the degree of trust between non-executives and executives.
5. The second problem is the business cycle. Consider the analogy of 'the wind' in golf where the golf ball goes further downwind. The wind can change. The business cycle and climate are difficult to predict. Targets set at the beginning of the year can 6 months later be easy or virtually impossible. One way to adjust for the business cycle is to compare your financial results with your peers (see www.obermatt.com for more explanation of this approach).
6. Thirdly, the choice of performance measures is not easy either - market related measures (such as share price or TSR), or non-market-related financial measures, or non-financial measures?
7. The problems of using relative measures are well known from those long-term incentive plans which use relative TSR: it is difficult to find good comparators and all too often the comparators are at different parts of the cycle, have different gearing and different growth/investment plans. It is possible to manipulate relative TSR and the incentive plan outcome by careful choice of comparators. On the other hand, genuine performance can go unrewarded because of anomalies in the benchmark or timing.

8. When using financial measures for target-setting, there are some important basic benchmarks to consider. Look at the history for ROCE, WACC, profit margins, sales growth, etc for your company and also for key competitors and industry norms. A high p/e ratio means the market is expecting high growth, so bonus targets should reflect this.
9. Financial measures only measure the past. However, many companies are increasingly looking towards leading indicators of future value and are incorporating non-financial measures in incentive plans.
10. Finally, whenever judgment is required in assessing the outcome it usually leads to additional cost as management have more resources to create and support arguments for judgment to be used in their favour.
11. Setting targets is difficult because there are lots of emotions are at play, there is a lot of self interest involved and the amounts of money at stake are large. If all parties do not all agree why the company is doing it in the first place it is doubly difficult. Start by reviewing what the overarching reward strategy objective is. Is it profit-sharing, for motivation or to satisfy personal monetary desires?

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

Why do we need bonuses at all?

12. It is partly history - in the early 80s bonuses might be 20%-30% of salary. Following North American practice FTSE 100 company practice had increased to 100% maximum by the late 90s, and since then a maximum opportunity of 300% salary is not unusual in large companies, though highly geared to performance. One view expressed was that this high level of bonus has been affected by the rewards available in private equity.
13. It was suggested that there is now an unquestioned assumption that high variable pay is a good thing. This assumption is even made by the public sector. But is it a good thing? Has it actually led to improved performance?
14. One participant had no doubt about the need for the variable package and its function – shareholders don't want to pay substantial rewards unless the performance is there. And a clawback mechanism is needed as well if subsequently performance is found not to be what was originally thought.

Bonuses should focus on the business priorities

15. Companies should set the bonus targets according to the business priorities at the time. One participant said "Talk to the FD about priorities and gear the bonus to his views, keeping the bonus as simple as possible."
16. Another said he finds setting targets for short-term bonuses fairly easy. Shareholders have expectations of company performance, and companies should gear the targets accordingly "don't deliver – zero; meet expectations – reasonable amount; exceed expectations – good bonus". He said it's harder to set targets for the long-term incentive. With relative TSR executives can't work out where they are. Companies end up with a mismatch of owners' and executives' view of performance which is not healthy
17. One person commented that setting bonus targets is not helped by publishing full details in the annual report.

Are personal targets for main board desirable?

18. Views differed on this. One person said that the contributions of individual executive directors are very different – eg operations director, finance director and sales director. Another thought this is just doing their different jobs and personal bonus targets were not necessary. A third thought it depended on the type of industry.

Does the traditional model of remuneration – salary + bonus + LTI – still work?

19. Someone suggested it is now easier to set targets for executives which encourage them to be risk averse and hoard cash. Another thought that the underlying model hasn't really changed as companies still want managers to maximise the flow of cash to shareholders, although he was challenged how this would work if we pay people on relative performance.
20. The purpose of being in business is to maximize the future cash flows to shareholders (there was general agreement to this).
21. It was felt to be difficult to introduce any new model of remuneration, because the ABI, despite appearing to challenge the norms of remuneration, are really resistant to anything out of the ordinary – "anything difficult".
22. There was a debate about relative growth in EBITDA as a long term measure of performance? A problem with EBITDA growth is that it is affected by financing decisions. Instead companies

could look at average ROCE over 5 years, paying out something, for example, at a threshold of say 7½% per annum.

23. There needs to be more emphasis on "value", which is ultimately reflected in the share price but can be hijacked by other factors. Cash is the source of value. Bonus should be linked to cash returns in excess of the cost of capital measures as a percentage of the value created.
24. Pay needs to match and reinforce the culture of the company. The example of a food company was given, which had quite modest bonus amounts and profit sharing for all employees who had been able to share in the long term success of the company. The culture emphasized performance and steady growth. The limited bonus opportunities removed the potential divisiveness that occurs in many companies which operate egregious pay for top executives.

Retention as a main driver of remuneration

25. "Retention is the biggest problem – talent is critical, and there are always people out there ready to outbid you for your talent Companies can have a couple of bad years and then aren't paying out so much and are at risk. So companies end up paying extra out of profits in order to retain." A different solution was offered "Skin in the game is essential to retention, and you have to ask executives to invest enough that it works as a real retention tool."
26. Another participant thought that companies worried too much about retention: "Most skills aren't unique – you can replace them if people do walk.
27. Companies who concentrate on retention rather than reward are not creating the next generation of talent.
28. Nevertheless there are problems with long-term incentive plans as retention tools. "The flaw is trying to retain people when the plan is out of the money – if you hold your nerve for another five years till the plan comes good, you'd lose all your people."

On moving towards the FSA/G20 remuneration code *(eg substantial bonus deferral; deferral of bonus into shares)*

29. Financial services organisations are a convenient scapegoat. The model will be extended to the whole of the economy. It is going to lead to severe pain for people used to very large bonuses and relatively low salaries. One said "I had this discussion with FSA people today – "I've got kids. I won't be able to pay the mortgage." The FSA is requiring bonuses to be deferred, but executives discount them "they're worth 10p in the pound. No-one believes in these plans". Another participant felt the trend to deferral was necessary to ensure the sustainability of the reward programme

Discussion on bonuses in financial services

30. Too big too fail is unacceptable to society – we have at least to ring fence the retail part if not separate it off completely. We should allow even the retail part to fail from time to time. Northern Rock and HBOS were not the failure of investment banking operation, but failure in retail banking lending and funding decisions, not just in retail but also in property related loans.
31. Another felt that investment (casino) banking should be separated: the point is that whatever happens, depositors should be protected.
32. There was a discussion about the traders' bonuses. Could we measure traders over a much longer period? No – profits are closed out short term, and you should reward traders short term. Bankers lend longer term. Traders and (investment) bankers are not the same thing. They have very different risk timescales.
33. The past 20 years has been an aberration because of a year on year decline of interest rates, when everyone appeared a superhero. Now we have returned to a much tougher normality.

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