THE REMUNERATION COMMITTEE DINNER

On 26th September 2011, MM&K held a dinner for clients, all of whom were Board Chairmen, CEOs or Chairmen of Remuneration Committees. Over dinner, there was a discussion about:

THE CASE FOR HIGHER PAY

Summary

- **Top executive pay is probably going to come down – in financial services because changed capital rules (amongst other factors) mean that profits will come down, and in non-financial companies where boards are realising that an internal replacement for a CE or other executive can be paid less in the current climate**
- **The performance leading to high pay will receive a lot more scrutiny in the future. Very different models of performance pay are needed**
- **The politics of high pay are huge, with the potential for lots of negative publicity. You need a clear and consistent story to tell.**

Cliff Weight (MM&K) introduced the discussion:
How can we make executive directors think and behave like owners? However honest they are, self-interest may make them behave in ways that maximise their personal rewards and wealth rather than act in the best interests of the shareholders. To make them like leaders, I want the CEO to be well rewarded if the company and the CEO is successful. Yes, I am in favour of high pay for successful CEOs. But defining success requires much wisdom.

The credit crunch showed up the weaknesses of current executive compensation: too short term, no clawback if results fall off a cliff, asymmetric rewards and far too little equity. Resolve these weaknesses and you can justify high pay.

Vince Cable’s attacks on executive pay certainly seem to have struck a chord with the man in the street, with much press coverage that executive pay is too high, that the ratio of CEO pay to average employee is too big and that there are still too many cases of large rewards for failure. To counterbalance this predisposition, companies must have a story to tell about their executive pay and the logic underpinning it.

High profits could be one justification for higher pay. Another arises when the executive is achieving great things: executives who have started to get a reputation in their industry will be tempted by offers elsewhere if their company cannot afford to pay to retain them.

But full justification requires the linkage to long-term shareholder value. The argument runs like this: in the short-term, you ask executives to achieve certain things which create a sustainable competitive advantage, which will lead to the company beating its competitors and growing market share, achieving higher profit margins and a higher return on capital employed than its competitors; in the long term this will result in an improvement in returns to shareholders. If no such strategy is in place, you have no story to justify high pay.

An energetic discussion followed, which included the following views:

1. One diner said he was clear that 'high pay' is a matter for company shareholders. He is director of one company where the shareholder is very happy to pay executives a substantial percentage of the uncapped increase in value expressed as a multiple of EBITDA, a percentage which ramps up for very high levels of profitability (although he admitted the executives don't feel this is high pay when 52% is creamed off in tax).

2. Another participant said that a high pay opportunity should go hand in hand with executives risking something themselves – he always expects his executives to put 'skin in the game' - at a level which reflects their personal financial circumstances. Another felt this was appropriate only for some executives – people who are entrepreneurial have a different mindset from operational people who probably would not want to make the same investment.

3. There was a discussion about what 'high pay' means, and why (as highlighted by the new BIS consultation on executive remuneration) general levels of executive pay have increased so much over the past 10 years when compared with average workforce pay or any general measure of share performance or financial performance. The MM&K/Manifest survey figures for the median FTSE 100 company show total remuneration has increased from £1.2m to £4.5m over the past 10 years, while the FTSE 100 index has fallen from 5,800 to the current 5,089. The value of a CEO to a company is ultimately only in the returns to shareholders. If those returns have not been there on average for major UK companies, it is hard to justify an average increase of 4 times over 10 years. It was pointed out that executive pay growth has varied considerably by region.

4. There was then a discussion about the fees for non-executive directors. Whereas NED fees have increased at the same rate as chief executive *salaries*, they have nowhere near kept pace with *total remuneration*, which includes increases in bonus opportunity and LTI grants. Yet the responsibilities and time commitment of NEDs has increased radically over the past 10 years.

5. One participant who is a director of a major charity said that the view in the NFP and public sectors is that private sector pay has got completely out of control. A Civil Service Permanent Secretary earns less than £200k in total, as does the chief executive of a major charity. The feeling in these sectors is that the private sector has lost any moral sense in this issue. He pointed to Japan where the disparity between average and top pay is much less.

6. Another diner challenged the validity of this viewpoint. He said that top civil servants have presided over a decline in productivity over a long period in which productivity in the private sector has consistently improved. 'It's a minor miracle that they get paid at all!' He was asked - what about the Fred Goodwins of the private sector? He said – it's particularly in manufacturing and engineering where we've seen a transformation in productivity.

7. The previous participant said 'we are all in favour of high pay. But there is a wall of public opinion against it. So what do we do? Is there a real move within industry to change private sector pay? If there isn't, there will be increasing Government interference and increasing taxation of higher paid people.'

8. Another said there are a lot of people in the public sector. I don't mind paying 50% tax – but not to pay for crap public performance. And there is no public support for maintain public pensions as they are.

9. It was then suggested that shareholders need to act more strongly in controlling excessive pay. They have tended to be dormant and benign. Perhaps a teach-in for

shareholders is needed. Another person thought that shareholders were not really concerned about high pay – their view is 'pay it and get on with it'.

10. Shareholders in listed companies hold shares for 8 months, compared with 3-5 years in private equity. This may well explain the trend towards increasing the proportion of the listed company package in the annual bonus. But also companies are leaving the stock market in large numbers.

11. This led to a discussion about the excessive levels of reward for partners in the largest accountancy and law firms where there are no external shareholders and £2m can be a normal earnings expectation. It was suggested that remuneration being is leveraged up through the operation of oligopolies which have allowed partner charge-out rates to rise to over £1,000 per hour. And these are usually limited partnerships now, so the individual's exposure is capped.

12. There was then a debate about the extent to which one man or woman, as CEO, was capable of making a difference to the value of a corporation. One participant said that the right individual can make a huge difference; that skin in the game is essential; and that pride in achievement and delivery is a more powerful motivating force than money.

13. But another participant described a situation of a company in trouble that wanted to pay executives largely in equity and also wanted them to invest. The executives were very resistant to this approach.

14. Another diner challenged the premise that the right executive can make a huge difference – aren't chief executives turning over faster – and too fast to make this difference? In the UK the average tenure of a CEO is now 4½ years compared with 6 years in the US. [MM&K note: CEO total service with the company is longer – about 11 years for FTSE 350 companies.]

15. The need to pay globally competitive packages has been used effectively to increase executive pay in international companies, with a knock-on to UK-focussed companies.

16. The discussion turned to definitions of performance for remuneration. For example, should shareholder returns be measured as a relative or absolute figure? One diner was emphatic that 'it is all about absolute returns. The relative figure is only an over-rider, a safety net. Shareholders want value, and they can invest in any sector.'

17. Paul Norris from MM&K explained the firm's research showing that there seems to be little linkage between the published KPIs of companies and their incentive measures.

18. Next we discussed the attributes of a successful chief executive. One participant said a good chief executive can run anything. Another said the skill set may be changing – for example pharmaceutical companies used to be run by scientists – now they are run by marketing people who buy the technology as they need it.

19. Not everyone thought the emphasis on products and marketing was always right. For example, customers might prefer it if major engineering-based companies were run by engineers. BP had a fantastic safety culture in the early '90s. And if safety is right it means that operations are right. But when the emphasis changed to value creation, the company was commercially more successful for a long time before its recent troubles.

20. Someone quoted the aphorism: no banker can run a bank, and no non-banker can run a bank. It is clear at the time of the credit crunch that most NEDs didn't understand the workings of their bank.

21. It is impossible to generalise about the skills that are needed to run a company – every company is different. (Although there is certainly never a good reason to cut safety expenditure.) But shareholders look to the chief executive for the plan, for the strategy, and expect him to be messianic about it, as well as building the right team.

22. How often is the right CEO in place? In day to day businesses there is probably a gap in many places.

23. Someone then expressed a view that executive pay will definitely start to come down. Investment banks, for example, will make less money, and this will knock on to executive reward. But even with lower pay, there will always be capable people willing to do the job.

24. Yes, and this will be a problem for government income tax takings, with pay lower and also people deferring pay in the hope that tax rates will come down in the future.

25. Everyone agreed that the right model to justify executive pay is to set a much lower base salary (cap of £400k?) and then add real performance pay. But not necessarily to motivate; different people are motivated by different things – money, honours, power.

26. Paul Norris asked - should non-executive directors be paid in shares or even share options? There was considerable support for the view that the right NED package is some cash, but principally payment in shares. This is in the interests of shareholders generally. NEDs need to face the risk of losing money if the share price falls. But not share options as they have the wrong dynamic.

27. It's the chairman and non executives who have to manage pay, not the shareholders, who are too remote. If the NEDs have shares they will have more interest. Participants all agreed with the person who said 'it's drivel that owning shares compromises your independence as a non-executive director'.

28. But why would someone want to take the experience of their whole career and take risks by becoming an NED? You are just a cheap consultant. No, said another, you can provide something consultants cannot provide, because they can only answer the questions that have been put to them, whereas the NED on the inside of the company can see the questions to ask.

29. And another said – a half-baked strategy fully implemented is better than a good strategy not implemented.

30. We discussed briefly moves to increase the proportion of women on boards (prompted by the new ABI report on corporate governance). Like any male directors, women directors want to do the job because they are good at their own job and they want to do a good job as an NED – for the achievement. And they can be as tough - 'My female chairman takes no prisoners!'

31. But women do also bring different talents – women are prepared to ask questions rather than having to appear an expert, and they have a different perspective. They may also (on average) have a different attitude to risk. It is notable that on Angels' Den (a female version of Dragon's Den in the US) none of the women have chosen to invest in the projects that come forward. This view was challenged – apparently in the US, 1/3 of top poker players are women.

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