EXECUTIVE REMUNERATION: THE REAL STORY BEHIND THE HEADLINES

In the wake of the banking crisis and the ensuing economic downturn, a huge media and public outcry against the culture of bonuses and excessive executive remuneration was heard. In this article, we examine the truth behind the eye-catching headlines and discuss the impact of such headlines on executive remuneration policy as well as emerging trends and best practices.

BANKERS, BONUSES, AND REGULATION

The huge furore over the size of bankers' bonuses, against a backdrop of bank failures and government bailouts, has led to increased regulation of the industry across the European Union (EU) region. The pay programmes prevalent in the financial services sector were widely perceived as a core contributor to the financial crisis. The subsequent robust regulatory response sought to curb excessive risk-taking behaviour and to align pay with longer-term, risk-adjusted performance within the banking industry. Practices such as linking bonus payouts to long-term organisational performance through deferral mechanisms, adjustment of bonuses pre- and post-payment (clawback and malus provisions), and the payment of bonuses in shares and equity-linked instruments have all been widely adopted.

Some companies, such as Barclays, completely misread the spirit of the times and have continued to pay out large, headline-grabbing bonuses. This decision is proving to be very costly in terms of reputation. The public were unhappy with bankers receiving huge sums of money that were not justified by their performance while the rest of the population faces austerity measures. The EU developed a radical approach to bankers' bonuses, and in February, it agreed to cap bankers' bonuses to one times the base salary (two times with shareholder approval). This cap covers not just bonuses but all variable pay elements (including long-term incentives). The political agenda is clear in the regulatory responses of individual countries within the EU. The British chancellor, for example, is threatening legal action against the EU over the proposal, which he fears will destabilise his country's financial recovery. Meanwhile, the Dutch government plans to cap performance-related bonuses in the financial services sector at 20%, going significantly beyond the new EU pay rules. Overall, Europe is becoming one of the most highly regulated regions in the world and this has created an uneven playing field across the global banking sector. There is a real risk that top talent and, indeed, whole companies may relocate to avoid the EU's stringent pay rules, causing widespread economic challenges for the continent's financial centres. Although Mercer supports regulation as a moderating influence on executive pay in principle, we feel that a global, rather than regional, response is required.

SHAREHOLDER ACTIVISM

For years, shareholders were criticised by the press and politicians for being too passive. In the wake of the financial crisis, public anger has directly influenced shareholders and strengthened their resolve to act. Several instances of shareholder revolts have been documented in recent years. The Novartis case of March 2013 not only cost the departing CEO $78 million, but also heavily influenced the outcome of the Swiss referendum on "golden handshakes" and bonus payments. In the UK, the scandal around the poor performance and unsound policies at Aviva caused the CEO to resign.

New regulation is being introduced in the UK that is in part focused on strengthening the influence of shareholders. Forward-looking remuneration policies must now be put to a binding vote and approved by a simple majority of shareholders. Any payments to directors that deviate from the approved policy will not be sanctioned. This model is likely to be replicated across the EU and will require remuneration committee chairs to take their duties around shareholder communication and engagement more seriously.

Executive pay is more than a shareholder issue, however — all stakeholders have a part to play. In an era of increased scrutiny of corporate behaviour, it is essential that companies maintain open lines of communication with a wide array of stakeholder groups all year round and not just at the end of the financial year.

REWARDS FOR FAILURE

Rewards for failure have long been a controversial area. All too often we have seen large payouts to departing executives of poorly performing companies, giving disproportionate reward. Companies need to demonstrate that rewards are explicitly linked to performance, with both upward and downward adjustment, to ensure that their variable pay programmes are functioning correctly.

A common theme among companies that got it wrong in the past was that policies on termination payments were poorly understood until they were actually triggered. Leaver provisions were often not clearly articulated or agreed upon before the trigger event. Shareholders were therefore not always able to assess the reasonableness of these arrangements until it was too late. To address such situations, there must be more clarity around what executives get when they join and also in the event of their departure from an organisation.

The UK's response to this issue was the requirement of an explicit disclosure on all leaver and joiner policies, which is approved and then binding. Any deviation from the agreed policy renders it void and payments can be recovered. Although we support shareholder activism, we feel the details should be left to the appointed independent nonexecutive directors. Shareholders should not need to micromanage the companies in which they invest.

RATIOS OF CEO PAY AND AVERAGE PAY

The ratio or pay gap between the highest and lowest or average earners within organisations has been one of the most popular topics with journalists and politicians. We believe this is far too simplistic a measure. Although it may be relevant when we consider a business operating in just one country, to assist in explaining year-on-year changes, the number quickly becomes meaningless when we extend the measure to multinational organisations, which may have low-cost operations elsewhere in the world, distorting the measure and making comparisons between companies meaningless.

TRANSPARENCY AND DISCLOSURE

Disclosure of senior executive pay is here to stay and is generally considered a good thing. However, it needs to be handled carefully. Transparency helps hold companies to account, but it can also fuel an unproductive debate. The bad news is that more transparency is on its way with the new EU directive coming into effect.

Executives like to compare their own pay against that of others, so companies find themselves striving for an elusive median, which in reality leads to an escalation of pay over time. Disclosure also fosters a market-driven perspective on pay programmes, making common practice morph into best practice, regardless of company strategy. For instance, the majority of long-term incentive plans use total shareholder return as a performance measure, regardless of whether it is meaningful to their own business structure — only because everyone else is doing it.

How does disclosure align with the privacy rights of an individual? The simple answer is, if you are a senior executive with legal responsibilities for your company, you have no privacy. It is unlikely that there will be any naming and shaming further down in the organisation, but we are starting to see disclosure of the number of managers within each pay band.

TAKING THE BLAME FOR EXCESSIVE PAY

Much ink has been spilt in trying to find the culprits for previous remuneration excesses. The truth is that all the groups involved (consultants, the media, investors and shareholders, politicians, and executives themselves) share the blame and need to work together to resolve the issues.

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