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# Board Walk

Briefing for Remuneration Committees

July 2010

## Non-Executive Directors – thin cats?

The recruitment market for chairmen and non-executive directors has very different dynamics from the executive market. Despite regulation's demands on boards, their fees have grown at a much slower rate than executive pay. Damien Knight investigates.

With the publication of the new MM&K-Manifest executive pay survey I thought I'd check out my hunch that non-executive director (NED) pay has not kept up with executive pay over the past 20 years, despite the hugely increased demands on NEDs by successive corporate governance regulations. I was able to take non-executive director figures from MM&K's 'Life in the Boardroom' survey published back in February. Then I looked right back to 1991 when the predecessor survey was first set up. Whilst the available data limits the NED comparison to mid-cap companies, Table 1 still gives a good idea of what has happened to fees since that time.

**Table 1 NED fee inflation over two decades**

| Turnover range | Chairman £100m-£1bn | NED £300m-£1.5bn |
|---|---|---|
| **1991** | | |
| Total fees | £24,500 | £12,500 |
| Days worked | 25 | 17 |
| Equivalent daily rate | £1,000 | £735 |
| **2009** | | |
| Total fees | £116,830 | £57,000 |
| Days worked | 53 | 31 |
| Equivalent daily rate | £2,141 | £1,800 |
| Increase in daily rate | 114% | 142% |
| Adjusted for inflation | 28% | 44% |

*Median values for geometrical range midpoints*

Although the total fees for both chairmen and other NEDs are four and a half times larger than back in 1991, the workload has more than doubled for chairmen, and nearly doubled for other NEDs. So, whilst British NEDs are not paid by the day, when we calculate a daily equivalent rate, we find effective increases of only 114% and 142% respectively over the period. This is not a great deal more than the increase in UK average earnings, which was almost exactly 100% (ie average earnings doubled). Adjusted for inflation, non-executive directors' fees went up 28% and 44% respectively compared with 20% for average earnings.

How does that compare with the movement in executive earnings? The extreme movement is that of FTSE 100 chief executives. Table 2 shows what happened to the FTSE 100 averages.

**Table 2 CEO earnings inflation over two decades**

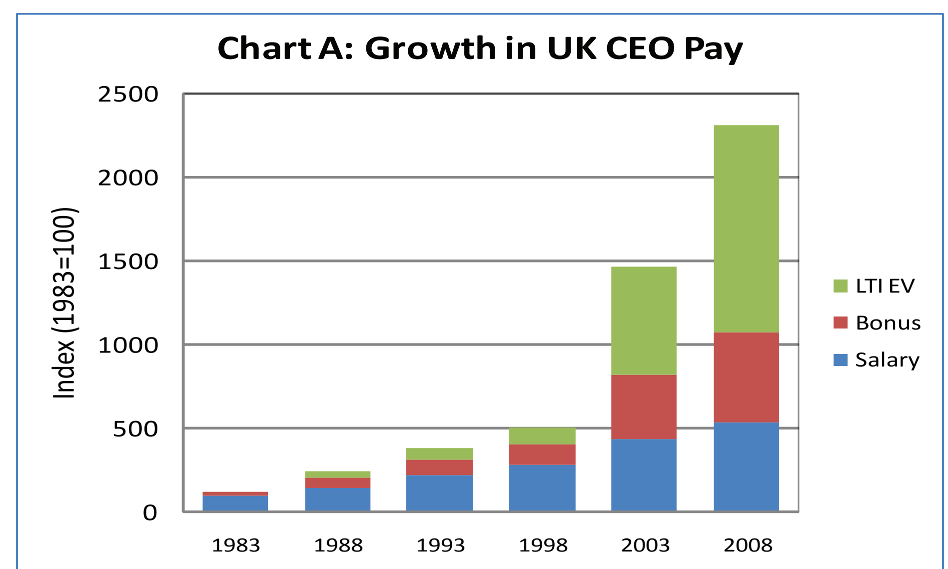
| Turnover range | FTSE 100 CEO | |
|---|---|---|
| | **Salary** | **Total Comp** |
| **1991** | | |
| Total compensation | £330,000 | £577,500 |
| Days worked | 300 | 300 |
| Equivalent daily rate | £1,100 | £1,925 |
| **2009** | | |
| Total compensation | £810,000 | £3,476,000 |
| Days worked | 300 | 300 |
| Equivalent daily rate | £2,700 | £11,587 |
| Increase in daily rate | 145% | 502% |
| Adjusted for inflation | 47% | 260% |

For the sake of a 'daily rate' comparison, I've made the assumption that a FTSE 100 chief executive works a six day week 50 weeks a year.

There are some clear conclusions from comparing these two tables. Look first at just the salary of the chief executive. It has increased over the period at a rate very similar to the NED's equivalent daily fee, and somewhat faster than that of the mid-cap chairmen. Again not out of sight in relation to average earnings increases over the 18 years.

(Note that the FTSE 100 chief executive receives pensions contributions on top of this salary figure, but since they are salary related they generally do not affect the rate of growth.)

The stunning difference is in the incentive elements. The total compensation figures in Table 2 add in the annual bonus payouts, and the expected value of long-term incentive grants. We know that bonus opportunity as a percentage of salary is two to three times what it was twenty years ago, and this is reflected in substantially higher bonus payouts; but it is the size of LTI grants that has really ballooned since they were generally introduced 25 years ago, as Chart A shows.




The comparison challenges a number of common assumptions about directors' pay.

(1) There is a belief that directors' pay is set in cosy clubs where directors sit on each others' boards and fix each others' pay, aided and abetted by unprincipled remuneration consultants. Of course the club myth doesn't stand up to a simple inspection of who is on what board, but these figures suggest there isn't even an implicit conspiracy to fix pay. In fact NEDs, who've got the say on executive pay, are apparently making rather a bad job of rigging their own. Also remuneration consultants seem to be missing a trick in jacking up the pay of the NED's who are the ones who hire them.

(2) Surveys (and often remuneration consultants) tend to think about pay markets as pricing jobs rather than people. And so we look to explain pay differences in terms of job differences (particularly nature of role & company size). The evidence seems to suggest that companies price people rather than jobs when it comes to NED fees. Whilst there is a wide spread of fees for both chairman and other NEDs, there is a very weak correlation between fee level and company size. Chart B overleaf shows the spread of fees for listed companies in the MM&K survey related to company turnover (the picture is similar if market capitalisation is used as a size measure). Assuming that companies are behaving rationally in determining



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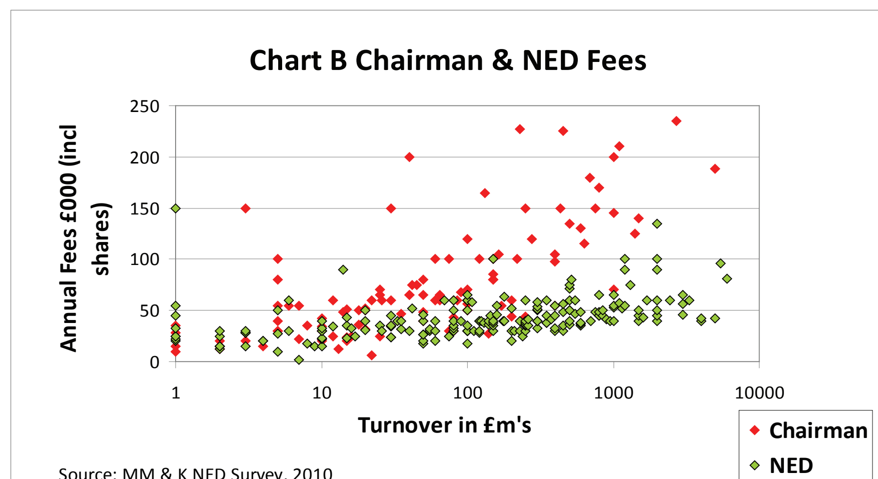
directors' fees, it looks as though they are less interested in fees paid by comparable size companies, and more with the qualities of the people they have hired and the expectations they have of these people. It seems companies of similar size can have entirely different perspectives on the value that the right NED can add – maybe because of the market situation or stage of growth of the company, or perhaps because of the attitudes of their current directors.




(3) Companies do not have the same reservations when it comes to their executives. According to some academics, remuneration committees can be unduly nervous about the dangers of losing their key people, and have an exaggerated sense of their irreplaceability. This is a spur to paying on the high side, and to taking a lenient view when assessing performance for incentives. Rather as in the US, Corporate UK has a strong belief in the impact a star chief executive can have. If a board believe the right CEO can swing total shareholder returns by £100m a year, they've nowhere reached the economic ceiling on his or her pay at the £3.5m median in Table 2 above, especially as most of this sum is contingent on delivering the returns in the first place.

Back in 1983, where Chart A begins, chief executive pay was largely determined by internal differentials. It seems extraordinary now that a large FTSE manufacturing company such as ICI or BAT at that time had 25-30 levels of management from the shop floor to the group head. But those were the days before digital communication and electronic management information. As the nature of business management has changed, the perceived value added by the top team has increased, and with it the amount the shareholder has been prepared to pay them. Greenbury and the Combined Code put this down to the 'ratcheting' effect of pay surveys. They were wrong! The truth is that in a highly competitive situation any market information is going to be inflationary. The encouraging thing for shareholders is that, through corporate governance machinery, they have managed to restrict the 'egregious' growth to the performance-related elements, leaving the main concern whether the performance standards are demanding enough and properly policed before large sums are paid out. But are they?

On a simple rule of thumb, if a company achieves median shareholder returns in a period of average stock market growth, the LTI plan will pay out an amount roughly equal to the economic value of LTI grants. Table 2 shows the median performing CEO would earn about £2.7m a year in incentives today, 11 times more than in 1991.

Should median performance justify this sort of increase? Is that what shareholders want? In his article below, The Performance Debate, Cliff Weight discusses the problem of setting CEO performance standards.

In fact stockmarket performance since 2000 has been so poor that performance-related earnings won't average this sort of increase, and rightly so, which highlights the importance of maintaining a genuinely contingent pay model, with the right balance of absolute and relative performance measures, and the right balance of short and long term performance.

(4) None of these performance considerations is currently relevant for the NEDs, because institutions and codes have proscribed performance-related reward for NEDs (except some shares) to avoid contaminating their objectivity. By doing this they have excluded the area of reward which has seen the major growth in recent years, and NEDs have inevitably dropped behind in the pay stakes. Moreover the executive directors have their NEDs to champion the case for competitive increases with shareholders. But who will argue the case for NEDs? The lesson of Chart B is that a non-executive director needs to set a high value on himself or herself at the time they are recruited. Once they are in they have to serve their time – they cannot leave for another appointment the way an executive does, and this weakens their bargaining power, and makes the NED market less liquid.

(5) Despite this inferior deal, headhunters say there's no shortage of candidates for NED appointments. A NED appointment fits well in the portfolio lifestyle of a newly retired executive, it can pay extremely well and it provides a continuing, if lesser, dose of power. Companies are clear who they want – board 'diversity' is well down the list of priorities, they want people with experience at the very summit of their own industry – CEOs and FDs – or people with the best access and experience in venture capital and M&A. If they find the right person they seem prepared to pay for them. But it's up the candidate to know their worth.

For more information please contact Damien Knight on 020 7283 7200 or damien.knight@mm-k.com.

## The Performance Debate

Cliff Weight discusses the tricky issue of setting targets that are fair to executives and shareholders.

You have to be incredibly talented to be a CEO or director of any quoted company. Only a very small percentage of the UK population achieve such status. Directors have to be great managers. They need expert skills in planning, managing and controlling. They must have strategic vision and also be skilful in execution. They have to be able to lead and manage the whole company. There is a shortage of good CEOs with the above skills. This is one reason why they command high pay.

Academic research (e.g. Bebchuk and Fried 2005 *Pay without Performance*; Wade, Porac, Pollock and Graffin 2006 *CEO Pay and Performance*) suggests they are also good at taking credit for success and avoiding blame for failures. Many are excellent at self publicity (although not all adopt this approach).

In the early 1990's prominent financial economists such as Michael Jensen and Kevin Murphy urged shareholders to accept large pay packages that would provide high-powered incentives. However, the academics also tell us that it is very difficult to identify the difference between the great and the good CEOs. Some may have a few great years and then fail, such as Sir Fred Goodwin at RBS or Lord Browne at BP. Others simply ride the wave of a bull market, positive economy and high gearing/leverage to produce what look like great results, whilst taking full credit for it.



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Being CEO is a high risk job. The average UK CEO lasts only 4.4 years in the role. (Bain research suggests the average tenure is 6 years in the US.) The risk of short tenure is one reason why CEOs demand high pay and generous severance arrangements. Companies whose succession planning means they have to recruit externally often have to pay substantially more than the 'going rate', in order to recruit. It is useful to think of CEO pay as being made up of a minimum going rate to keep the CEO satisfied, plus a share of the upside if he or she is successful.

Shareholders demand alignment of CEO pay with returns. The Remuneration Committee has to face up to this challenge. It is not an easy task to retain and motivate the CEO and top executives without excessive pay and also meet the other numerous desires and guidelines of investors. Remuneration Committees are struggling to walk the fine line between incentivising their CEOs with tough targets, and motivating and retaining their services. Many Remuneration Committees seem loath to upset their CEOs and this results in targets that are easy to attain, lower than market expectations and incentive plans that focus on short term objectives.

Larger companies are among the worst culprits as they have much more complex long term incentives with multiple target thresholds. This increases the potential for some payout before the overarching target is attained. Damien Knight' article above shows just how high the rewards for mediocre performance can be.

In summary:-

- Rem Coms are loath to upset CEOs.
- This results in easy incentive targets and focus on the short term.
- Large companies seem to be more loath than others to upset their CEOs.
- Large companies have introduced complex LTIPs which increase the potential for payout and divert attention from the overarching goal of long term success.
- Institutional shareholders' guidelines have historically emphasised relative total shareholder return measures, which has allowed generous rewards for executive directors even when absolute returns to shareholders have been poor. This emphasis maybe changing.
- There has been insufficient consideration of relative financial operating measures (e.g. profit or EBITDA growth, ROCE) as a means of measuring how well a company and its management is performing compared to its competitors and others in related industries.
- So, a combination of some relative and absolute targets may be the way forward.

For further information contact Cliff Weight on 020 7283 7200 or cliff.weight@mm-k.com

### MM&K gets high ranking

**The current Hemscott analysis of remuneration advisors to listed companies shows MM&K ranked 11th out of a total of 90 different firms mentioned in remuneration reports – in a tie with Ernst & Young, and above well-known firms such as Hay Group and Monks Partnership. We have a particular strong position with mid-cap companies. Hewitt New Bridge Street still ranks first despite the merger of Towers Perrin and Watson Wyatt.**

## New FRC Codes

The Financial Reporting Council (FRC) has just issued two important corporate governance codes.

### 1. The new UK Corporate Governance Code

In May the FRC published its new corporate governance code (dated June 2010), replacing the old Combined Code which was first issued in 1992. Changes to the remuneration section of the Code are as follows:

Performance-related pay policy The previous Combined Code provisions put the emphasis on alignment of interest with shareholders and providing keen incentives. This is replaced by a new Supporting Principle that performance-related elements should be stretching and designed to promote the long-term success of the company.

Design of performance related pay (Schedule A). New provisions require incentive remuneration to be compatible with risk policies and systems, and encourage the inclusion of non-financial performance metrics and the introduction of claw-back arrangements to be used in the exceptional circumstances of misstatement or misconduct. There is no longer any mention of "relative measures such as total shareholder return (TSR)".

***MM&K comment:*** *At first sight the changes to Code are slight, and largely reflect the good practice requirements proposed in the FSA and Walker reviews of remuneration/corporate governance in the banking industry – risk alignment, claw-back and use of non-financial metrics. It is hard to imagine the first two presenting a genuine priority outside the banking industry (and in fact the FRC dropped an earlier proposal to require the risk adjustment of bonuses in the Code).*

*However, the change in emphasis for incentive measures is important. The focus on long-term success of the company marks a genuine concern with the longer term, and a recognition that the market does not always successfully price actions which support long term success.*

*Remuneration committees are also challenged to ensure that the very substantial incentive payments that executives now receive are justified by stretching performance. (See Cliff Weight's article The Performance Debate.)*

*The use of relative total shareholder return for executive performance has been fraught with technical and communication problems, and its demotion is welcome. (There has also been a suggestion that the total reliance on relative returns for measuring fund manager performance has led to short-termism and a failure of investors to engage with companies - eg Walker). Companies using relative TSR for long-term incentives may wish to review their choice of metrics.*

Other parts of the new code also affect remuneration and its design: there is a new provision that the directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the "business model") and the strategy for delivering the objectives of the company. Then, to improve risk management, the board is made explicitly responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. All directors of FT350 companies will be subject to annual election by shareholders.



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***MM&K comment:** There is currently a gap in reporting, and setting out in layman's terms the company's strategy for generating long term value will enhance the ability of investors and other users of reports to assess the disclosures required under the Business Review. The FRC notes that there was general support for these proposals in the consultation, and for the associated principle to make explicit the link between remuneration and the long term success of the company. Remuneration committees will want to ensure there is total compatibility between the reported value creation strategy and the metrics of performance-related remuneration, especially long-term incentives. This may require a review of current plans.*

*Shareholders will be able to signal dissent on remuneration by voting against the re-election of the Chair of the Remuneration Committee and its members, and close relationships with leading shareholders is advised – as encouraged elsewhere within the Code. The new Code applies to accounting periods beginning on or after 29 June 2010 and, as a result of the new Listing Regime introduced in April 2010, applies to all companies with a Premium Listing of equity shares regardless of whether they are incorporated in the UK or elsewhere.*

## 2. The new UK Stewardship Code

Hard on the heels of the new govenance code for companies, the FRC published on 3 July its new stewardship code, aimed at institutional investors generally, but particularly at fund managers who manage investments on behalf of institutional clients such as insurance and pension funds. The new Code adopts wholesale the seven-principle stewardship code issued by the Institutional Shareholders' Committee (ISC) last November, making slight amendments only to pick up the shareholder elements of the old Combined Code, and to mirror the obligations of boards under the UK Governance Code to engage with shareholders. The Code (and its ISC prototype) are aimed at encouraging the engagement of investors with the companies they invest in, to help improve long-term returns to shareholders. Engagement in the first instance means talking regularly to companies, particularly the chairman and chief executive, and not just in response to crises. If there are problems that are not resolved, it means being prepared to take action, if necessarily jointly, and ultimately calling for an EGM/board changes.

The Code provisions are mainly concerned with the requirement for clear policies on the different levels of engagement and disclosure of these policies and subsequent adherence to them.

Fund managers are free to engage or not, and will negotiate their client mandates accordingly. But they should disclose their policy, report compliance activity, and explain their investment model if they choose not to engage. The Code emphasises that this is not a recipe for micro-management of investee companies, and selling the shares always remains an option. This month the FSA begins consultation to make the Code compulsory for fund managers authorised to manage institutional funds. The door is left open for more fundamental revision in the future, and this is likely, as there are wide concerns about some inherent conflicts and impracticalities in the process of engagement. The Code's working will be reviewed in the middle of next year. The ISC has recently announced the formation of a new Institutional Investment Council (IIC) which will work with the FRC on aspects of the Code.

***MM&K comment:** The impetus for the Code came from Sir David Walker in his review of corporate governance in banks. He appropriated the term 'stewardship' to distinguish the responsibility from the governance responsibilities of company boards. His chapter on the engagement responsibility of shareholders is probably the most original and intellectually profound in the review, and he recognised it had implications far beyond the banks. He differentiated two legitimate investor models – buying and selling to optimise short-term returns, and owning for the long-term. He said some types of investing institution have no choice but to follow the second model. Walker – ex Treasury/Bank of England and senior City player – displayed his confidence in the economic effectiveness of the Private Equity model (he carried out a review the PE industry in 2007). He saw this model offering close ownership attention, a clear investment horizon and lock-in of investors. He transferred this confidence to a belief that, for publicly traded companies, investors following the ownership model are more likely to improve long-term returns by engaging than by selling problem shares. He also expressed a belief that larger shareholders have a moral obligation to engage. Fund managers will have no choice but to sign up to the Code, but it remains to be seen whether the Code will change shareholder behaviour. UK fund managers already vote their shares; but many have reservations about full engagement, not least the resource implications, the risk to reputation and investee relationships by putting their heads above the parapet, and a sense of individual powerlessness where there is an entrenched board.*

For further information about either code, contact Cliff Weight or Damien Knight on 020 7283 7200, cliff.weight@mm-k.com, damien.knight@mm-k.com.

## MM&K/Manifest Executive Director Total Remuneration Survey

The 2010 survey identifies the weakening link between CEO performance and remuneration. There is a poor correlation between remuneration and shareholder value among FTSE 350 companies. The Median FTSE 100 CEO remuneration is up 5% to £3.1 million since 2008, whilst average earnings per share declined 1% over the same period. CEOs of larger companies now enjoy up to 300% of their salaries as annual bonuses.

Our authoritative survey was widely reported, including by The Financial Times, Telegraph, Independent, Guardian, City AM, Radio 4 and 5 Live. ***For information on ordering go to www.mm-k.com.***

## Budget Briefing

MM&K have published a full briefing letter on the 22nd June Budget. If you have not received a copy and would like one please contact Mike Landon on 020 7283 7200 or michael.landon@mm-k.com



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