

Remuneration committee briefing

Insight on boardroom pay and incentives

Europe | Autumn 2009

Originally published by Watson Wyatt Worldwide

Executive pay practices around the world:

'Watson Wyatt global executive pay study 2009'*

This year, Watson Wyatt carried out a study of the extent to which global convergence has already happened in executive pay practices, together with the prospects of this continuing to happen around the world in the years to come. The study covered not only corporate governance aspects but also CEO pay levels. We discuss in this article the key findings and conclusions.

In essence, although very considerable convergence has already taken place, it is unlikely that a complete 'coming together' of pay practices will ever occur – due to differences around the world in business approaches (market led, corporatism or statist) and cultural norms.

Introduction

The '2009 Watson Wyatt global executive pay study' involved the review of executive pay practices in 12 countries, namely Belgium, Brazil, France, Germany,

Hong Kong, Ireland, Italy, Japan, Netherlands, Russia, the UK and US. These countries together comprise about 75 per cent of G20 GDP. We looked at nine executive pay practice variables, including package quantum and the 'mix' of pay components. The study examined where convergence of practices has already occurred and tested our working hypothesis that there are practical limits to this.

In our judgement, the evidence revealed by the study supports our working hypothesis. Although the world is indeed 'becoming a smaller place' there are practical limitations on just how homogenous executive pay practices can become. We do not regard this as being in any way a failure of the thrust in recent years towards convergence on corporate governance and executive pay practices. It merely reflects that, for example, the US is more entrepreneurial in nature, with Continental Europe operating by way of social contract and Asia and Latin America having a more concentrated economic ownership.

At a glance

Executive pay practices around the world

A look at the prospect of further global convergence in executive pay.

Innovation in incentives

Changes to incentive plans following recent economic turbulence.

Back to the future?

The tax increases announced in the Budget are starting to have a profound effect on the way that companies are thinking about executive pay.

Figure 1. Who sets executive pay?

	Final recommendations on executive pay			Final sign off executive pay				
	Compensation committee/similar	CEO	Board of directors	Remuneration committee	Supervisory board	CEO	Board of directors	AGM
Belgium	✓						✓	
Brazil	✓						✓	
France	✓						✓	
Germany	✓				✓			
Hong Kong	✓						✓	
Ireland	✓			✓				
Italy	✓						✓	
Japan	✓			Rarely		✓		
Netherlands	✓							✓
Russia		✓	✓			✓	✓	Rarely
UK	✓			✓				
US	✓						✓	

*'Executive pay practices around the world' is available on request.

Figure 2. Disclosure requirements

	Disclosure	Policy for executives	Detail in policy disclosure	Aggregate	Detail – CEO	Detail – board	Detail – top five highest paid	Base salary	Incentive type and quantum	Pension	Value of benefits	Termination provisions ³	Appointment of advisors
Belgium	GR ¹	✓	Brief	OEX ²	✓			✓	✓	✓	✓	✓	
Brazil	N/A ⁶												
France	DRR ⁴ for CAC40 ⁵	✓	Brief				✓	✓	✓	✓	✓	✓	
Germany	GR/notes of accounts	✓	Brief			✓		✓	✓	✓	✓	✓	
Hong Kong	Annual report	If it exists	Brief	Senior managers	✓	✓		✓	✓	✓			
Ireland	DRR ⁴	✓	Brief			✓		✓	✓	✓	✓	✓	
Italy		✓	Brief	Share awards		✓		✓	✓		✓	✓	
Japan		If it exists	Brief	EDs ⁹				Total amount paid					
Netherlands	DRR ⁴	✓	Brief	Share awards		✓		✓	✓	✓	✓	✓	
Russia	FSFM ⁸			EDs ⁹				Total amount paid					
UK	DRR ⁴	✓	Detailed	Share awards		✓		✓	✓	✓	✓	✓	✓
US	DRR ⁴ (CD&A)	✓	Detailed ⁷			✓	✓	✓	✓	✓	✓	✓	✓

Notes

- 1 General report.
- 2 Other executive officers.
- 3 Agreements with directors or employees providing for compensation if directors resign or are made redundant without valid reason or if employees' employment ceases because of a takeover bid.
- 4 Directors' remuneration report.
- 5 French top 40 listed companies.
- 6 It is likely that Brazil's Comissão de Valores Mobiliários (Securities and Exchange Commission of Brazil) will soon introduce disclosure, it is currently finalising public consultation. Currently the public companies legislation obliges companies to disclose only the aggregate amount paid for the board members and statutory directors.
- 7 Including, for TARP companies, certification that pay is not encouraging 'excessive risk'.
- 8 Federal Services for Financial Markets.
- 9 Executive directors.

Executive pay practice variables

Governance of executive pay – compensation/remuneration committees

In all of the countries participating in the study there is some form of corporate governance code or legislation governing executive compensation.

For publicly-listed companies, outside directors, non-executives or supervisory boards have taken on the role of representing the best interests of shareholders, typically in a 'negotiated' process with senior executives and particularly the CEO. As shown in **Figure 1**, the most common model is for companies to nominate a sub-committee of the board to act as a remuneration committee (or compensation committee).

There are certain basic tenets, such as executives should not attend a remuneration committee meeting when his/her own pay is being discussed,

remuneration committees should be composed of, and chaired by, independent non-executives and that they should have access to professional remuneration advice if this is considered necessary. There are also ever-strengthening views on the independence of remuneration committee advisers from the influence of executive management.

Say on pay

In some countries, a vote on executive remuneration policies – also known in the US as 'say on pay' – is being implemented to address the perceived problem of controlling executive pay. 83.3 per cent of the territories surveyed have a shareholder vote on the introduction of new share plans (the exceptions being Germany and Russia) but the same percentage do not currently have an annual advisory vote on the remuneration report (only the Netherlands and UK have such votes at present).

Figure 3. Contracts and severance payments

	Severance pay – leaver				Severance pay change in control				Contractual provisions		Comments
	Months	Base salary and benefits	Variable	Performance based	Months	Base	Variable	Performance based	Provisions re early retirement		
Belgium	12	✓	✓	✓	12–18	✓	✓	✓	✓		
Brazil	Not common – used for top executives on discretionary basis										
France						24	Total cash	✓	✓		
Germany	24	✓	✓	✓		150% of termination cap				Severance – lower of 24 months or remaining contract	
Hong Kong	Not common, and when provided typically less than 12 months										
Ireland	12 or less	✓	✓	✓	12 or less	✓	✓	✓	✓	Companies should review pension entitlements – no reward for failure	
Italy											
Japan	N/A — normally no severance pay								N/A	N/A	
Russia	No limits specified for severance										
Netherlands	Maximum of one year’s salary										
UK	12 or less	✓	✓	✓	12 or less	✓	✓	✓	✓	Companies should review pension entitlements – no reward for failure	
US	Typical plan provides 6–24 months for general severance and 12–36 months for CIC severance (including bonus). However, there is no mandatory or statutory severance.										

Disclosure of executive pay

There has been progression in the tightening of disclosure requirements in Europe and the US over recent years, leading to increasing prevalence of detailed individual remuneration disclosures. The most comprehensive reports continue to be seen in the largest companies in the US (indeed, US executive pay disclosure is by far the most detailed in the world – an average US publicly-listed company has 30 pages on executive pay). The position is set out in **Figure 2**.

Contracts and severance payments

Whereas in the past potential severance pay was high in many countries, over recent years pressure from investors and corporate governance organisations has been to reduce notice periods. Across Europe recent legislative changes have made 12 or 24 months notice the norm for executives as shown in **Figure 3**.

Market positioning of remuneration

Most companies have some level of governance guidelines in place in relation to the positioning of their remuneration packages against the market. Typical statements about remuneration philosophy focus on relatively generic principles such as ‘remuneration should be sufficient to attract, retain and motivate’, ‘there should be a transparent procedure for setting policy and quantum’, plus ‘pay policy should be considered relative to comparator group’ and ‘account being taken of total potential remuneration’. Such statements, together with those

such as ‘avoiding paying more than necessary’ and ‘pay should not be excessive’, together with ‘a significant part of pay should be performance-related’ are frequently seen.

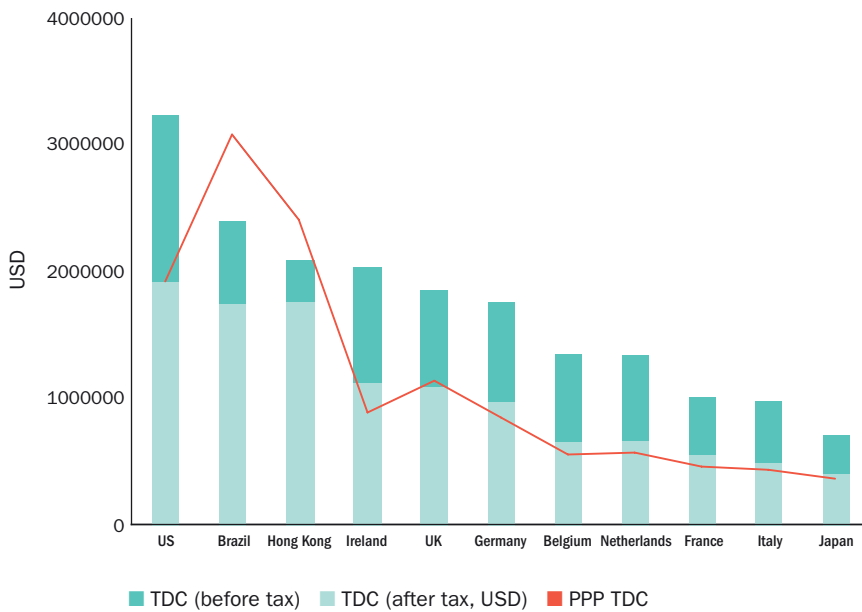
Quantum of reward: market remuneration data

To complement our review of corporate governance and remuneration policy we carried out a ‘snapshot’ analysis of CEO pay in local, publicly-listed companies across 11 of the 12 countries. The companies reviewed had revenues in the range of USD 1–3 billion and we looked at total direct compensation (TDC) (basic salary, last annual bonus paid, together with the ‘fair value’ of long-term incentives (LTIs) at grant). We reviewed pre- and post-tax TDC and used the concept of purchasing power parity. In addition to looking at absolute values we also looked at the package ‘mix’, please see **Figures 4 and 5**.

It will be seen that incentive pay forms the most value in the package for a significant proportion of the countries. Indeed, in every country except Japan more than 50 per cent of TDC is in the form of variable pay.

It is also in incentive pay that there has historically been more variation in practice by geography, largely reflecting underlying local values and economic development. However, with increasing globalisation this is an area where, at least in terms of quantum, there has been greater convergence over recent years. It has to be said that with the onset of the recession, it is likely that many countries will take a

Figure 4. CEO remuneration packages in companies with revenue between USD 1-3 billion – TDC quantum



similar approach, for example with basic pay freezes and increasing the degree of difficulty of stretch when setting the ‘calibration’ of payout to performance attained under incentive arrangements.

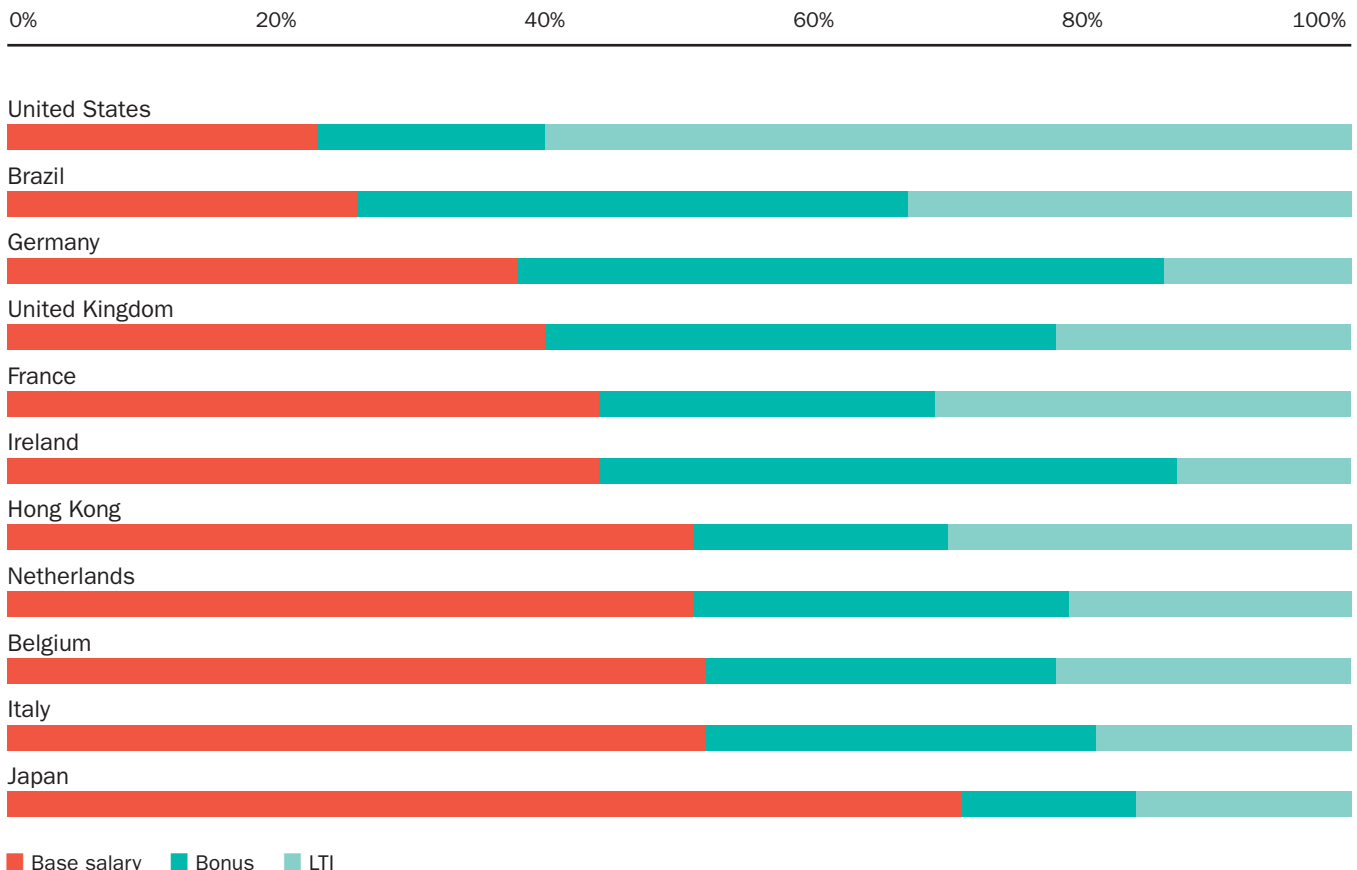
Incentive plans – short-term/long-term

In the past, on both short- and long-term plans there has been little homogeneity of performance targets between sectors or geographies. Factors impacting this have included the robustness (or otherwise) of performance management systems to support the use of individual/team-based short-term metrics, the appropriateness of different non-financial measures in different industries – for example the use of health and safety metrics in the oil industry, and local cultural and investor views on whether delivering a certain financial outcome is more or less important than how that outcome is achieved.

In some countries there is also discussion of ‘re-pricing’ share options that are ‘underwater’ (that is, the exercise price is less than the current share price such that the vesting any value of award looks unlikely).

There are many approaches to re-pricing options. Though it has occurred in some high-profile cases in the US, re-pricing of share options is a distinctly minority market practice (and the majority of re-pricings have been in the technology sector).

Figure 5. CEO remuneration packages in companies with revenue between USD 1–3 billion – ‘mix’ of TDC package components



A far more common situation that remuneration committees currently find themselves having to look at is the size of future share incentive awards. Recent falls in share price mean that maintaining the same level of award in terms of 'face value' expressed as a percentage of salary can lead to dramatic increases in share capital dilution and also the 'gain potential'. However, maintaining the same level of 'expected value' can also lead to potentially massive share awards. One solution is determining the size of share awards in terms of number of share grant ranges.

Even simpler than this is simply 'dialling back' the size of previous awards in a way that reflects to an appropriate degree the level of fall in share price since the time awards were last made. It will be appreciated that where a company's share price is more than half that previously, an approach will be warranted that is more generous than where a company concerned has joined the '10 per cent club' (for instance, where the current share price has fallen by at least 90 per cent).

In financial services particularly, there is now also far more discussion around the world about bonus deferral and also 'claw-back' mechanisms. It is inevitable that the greater oversight of executive pay in financial services will to some extent have a trickle-down influence on the wider market.

Conclusion

The current global financial crisis has added a further twist to the considerable convergence in executive pay practices that has taken place over the past 25 years. This is particularly the case in respect of the stipulation that remuneration needs to be linked to sound risk management principles in financial services organisations. It has also had a significant impact on pay actually realised in the current year as performance targets are missed on short-term and long-term incentive plans and also on how companies make awards under incentive plans for future years. Companies are responding to external pressures on remuneration processes and practices (such as government activity, media attention, public awareness and investor views).

However, it is most unlikely that full convergence on executive pay practices around the world will ever be attained. This is due to the cultural norms and varying stages of business development across territories. In our view, this does not represent a 'failure of corporate governance'. It simply reflects the fact that although the world has become smaller it is still much larger than some think! (Please note that this study was carried out in April 2009 and that corporate governance practice/legislation may have changed subsequently.)

calvin.jackson@towerswatson.com

Innovation in incentives

The economic turmoil of the past 18 months has put executive pay at the top of many agendas. Shareholder anger, media attention and public frustration have led to remuneration reports being voted down by shareholders and an outpouring of recommendations from the UK government, the FSA, the G20 and Europe.

With so many pressures, changes to executive pay seem inevitable. Yet reactions within UK PLCs have been surprisingly muted. In fact, Watson Wyatt's pay policy database, which collects information on all FTSE companies who amend or introduce new incentive plans, shows a significant dip in activity between 2008 and 2009. Companies are not changing their incentive plans, and, where they are, they are for the most part following standard market practice. The innovation and diversification that we may have expected has simply not yet emerged.

It may be that the very pressures which will drive innovation in the future are, at the moment, encouraging caution. In a year in which many long-term incentives did not pay out, annual bonuses were reduced and base salaries were frozen, to try to introduce a new and unfamiliar incentive plan to investors would have been a risky decision. It is probably only in the 2010 AGM season that we will really be able to measure the impact of the recession on executive pay and incentive design. For the moment, we can only suggest how companies may choose to address the challenges of disgruntled shareholders, increased regulation and a higher tax environment.

The move to tax efficiency – the impact of a higher tax environment

A recent Watson Wyatt flash survey of UK HR professionals found that 39 per cent were considering engaging with executives to find tax efficient pay routes following the recent budget. With this in mind, one major innovation may be the redesign of share plans so that they benefit from capital gains tax rather than income tax treatment by the use of structures such as joint ownership or 'alphabet' shares.

In 2009 we have already seen a slight increase in the number of companies changing or introducing option plans, perhaps indicative of companies dusting down tax-efficient Company Share Option Plans (CSOPs) as a first reaction to higher tax rates.

For more on how companies are reacting to the Budget tax changes, see 'Back to the future?' overleaf.

Ensuring pay for performance – diversity and risk adjustment in performance metrics

In recent years we have seen a great deal of homogeneity in the use of performance metrics, particularly in long-term incentive plans. However, recent criticism that some performance metrics have encouraged risky behaviour, concentrated excessively on short-term growth and provided arbitrary payouts unrelated to company or executive performance may bring greater diversity in the future.

This is still an issue in a great deal of flux, in particular because shareholders are not always in agreement with regulators. For example, the FSA has highlighted the sensitivity of relative total shareholder return (TSR), a common measure in long-term incentives, to outside influences, yet the ABI continues to see this as a preferred metric due to its direct links with shareholder value creation. In short-term incentives a move towards internal and risk adjusted metrics may provide closer linkage between pay and performance, but this will be at the cost of transparency, something many shareholders will not welcome. Companies will need to strike a balance between these conflicting pressures, but the result will almost certainly be a growing diversity in the types of performance metrics used by organisations in both short- and long-term incentives.

A structure for the situation – one-off and turnaround plans

Watson Wyatt's 2008 pay policy database showed a noted increase in companies in difficulty or in the middle of re-organisation introducing one-off 'turnaround plans'. These offered large rewards, usually over more than three years, based on performance metrics particularly linked to the turnaround of the company. As the recession leads to more companies restructuring, often with new executives in place, we would expect future innovation and growth in turnaround plans that meet regulators' desires for incentives more closely tailored to business needs, and allow companies to recruit the high quality executives needed for successful reorganisation.

Aligning with shareholders – the return of options?

Performance share plans (PSPs) have dominated the UK market in recent years. However, payouts from some share plans despite poor performance in the last 18 months may result in a renewed interest in option plans. These have the advantage of providing greater transparency for shareholders and executives while setting a definitive 'floor' below which no value will be produced, regardless of relative performance.

The disadvantage to this is the possible perception that companies are taking advantage of unsustainably low share prices to make windfall grants to executives. As such, one area where we may see increased innovation is in the use of capped options, or some sort of whole-share 'synthetic option', which flexes depending on share price. This sort of structure would take the extreme scenarios out of option plans by providing some value to a high performing company in

a poor market while capping payout to prevent excessive value being passed to executives in a growing market.

Ensuring long-term gain – changes in package balance

As regulators and shareholders demand sustained longer-term performance to justify high payouts to executives it seems likely that the balance of executives' packages will move towards greater long- or mid-term elements. The main manifestation of this will probably be in the introduction of long- or medium-term elements into short-term incentives through deferral and claw back arrangements. This is a trend we have already begun to see in 2009, with two FTSE 100 companies introducing an element to their short-term incentives where deferred bonuses will be forfeited should it be determined that the performance that led to the award being granted was not correct. In addition, there has been an increase in the number introducing deferred bonuses this year.

More power to shareholders? New regulation and changing relationships

In many countries the recession has reopened conversations on 'say on pay' and executive pay disclosure. However, the high level of regulation already present in the UK makes it unlikely that we will see widespread change in the formal relationship between shareholders and companies. It is possible that additional regulation may come into force, for example giving shareholders the right to remove remuneration committee chairmen, have a say on the appointment of remuneration consultants, or even sit on the remuneration committee, but these changes do not seem probable in the near future.

Instead, what we may see is a shift in the relationship between company, shareholder and regulator. Media criticism that shareholders did not do enough to curb poor pay practices in the boom years may result in increased shareholder involvement going forward, as suggested by recent majority no votes on remuneration reports. Companies will also have to become used to tighter, tougher and more specific regulation. The outcome may well be a more consultative, but perhaps also more painful, incentive design process.

It is still very difficult to predict what the future of incentives will look like. What is certain is that the pressures currently on executive pay will produce changes, perhaps radical, in the structure and design of incentives. Shareholder and regulator attention will probably lead to more diversity and innovation in incentive design. Companies will need to look beyond what the majority are doing and focus on what their business strategy, financial performance and industry suggest they should be doing. As a result, incentives should be even better placed to drive executives to produce high-performing businesses for the benefit of shareholders and the wider world.

katy.bennett@towerswatson.com

Back to the future?

The tax increases announced in the Budget are starting to have a profound effect on the way that companies are thinking about executive pay.

The 50 per cent income tax rate planned for April 2010, combined with the restriction of tax relief on pensions from April 2011 for those whose income exceeds £150,000, are driving companies to return to tax-drive pay; for example share incentives taxed primarily on a capital gains tax basis at 18 per cent and alternatives for those who will be 'un-pensioned' in future.

There are many things for HR teams and remuneration committees to review:

- Have you considered the pension pitfalls for high earners during the transitional period?
- Do you use, to the maximum, tax approved share plans such as CSOPs?
- Should you adopt share incentive plans within the CGT regime?
- Have you reviewed other methods of increasing the tax efficiency of share plans and pensions such as Employee Benefit Trusts?
- What alternative to the registered pension scheme will you offer after 5 April 2011?

Pension pitfalls – the transitional period

22 April 2009 to 5 April 2011

There are strict and complex rules designed to prevent the loss of tax from increased pension savings ahead of 2011.

They catch those whose income exceeds £150,000 in this tax year **or either of the two previous tax years**, if

- their pension savings increase, and
- exceed a limit of £20,000 per annum (or in some cases, up to £30,000 per annum).

If caught, higher rate tax relief is lost immediately on increased contributions (or benefit accrual).

This will catch unexpected cases: for example a company pension contribution made through bonus sacrifice, or in a severance agreement.

They may also catch changes on promotion into a new tier of pension provision, or where a new recruit is given a level of pension benefit that is not applicable to at least 20 other employees – see **Figure 6**.

Figure 6. Pension pitfalls – the transitional period

Transitional rules – who may be caught?	'Risk factors' for pension changes for high earners
Taxable income in excess of £150,000 in any one of three tax years brings an executive into the 'danger zone' where any changes to pension values might not get higher rate relief.	<ul style="list-style-type: none"> – Recruitment – Promotion – Bonus sacrifice – Severance – Increases to AVCs
Taxable income includes not only salary, bonuses, taxable income from share incentives and benefits in kind but also personal income such as interest, dividends and income from property.	

Tax efficient share plans

Existing share plans should be reviewed – for example, can they be made more tax-efficient for participants by:

- increasing the length of the
- ‘exercise window’ after vesting, to allow tax planning
- using a CSOP to deliver the first £30,000 of shares under an option or LTIP?

There are also tax-efficient share plans that retain the overall structure and motivational aspects of existing vehicles, which have acceptable shareholder ‘optics’ and which deliver their profits mainly or wholly as capital gains rather than taxable income. The trick, as always, is to focus on arrangements that are linked to business objectives, are likely to be acceptable to shareholders and executives and are as robust as possible against future changes in HMRC interpretation or new legislation.

It is impossible to guarantee that the tax regime will not change further but our experience is that companies have a very real appetite for exploring what may be possible to improve the tax efficiency of their expenditure on remuneration. Remuneration committees can then make an informed choice about the best way forward.

At a recent seminar on the impact of the proposed tax changes on executive reward we asked the 48 major organisations attending:

“Do you expect that your company will make changes to its long-term incentives to make them more tax efficient?” Their answers are summarised in **Figure 7**.

Pension alternatives from April 2011

Companies are starting to look at what replaces registered pensions for executives after 5 April 2011. Cash supplements are unattractive because they will be taxed at 50 per annum plus employee and employer NIC. Current front-runners include:

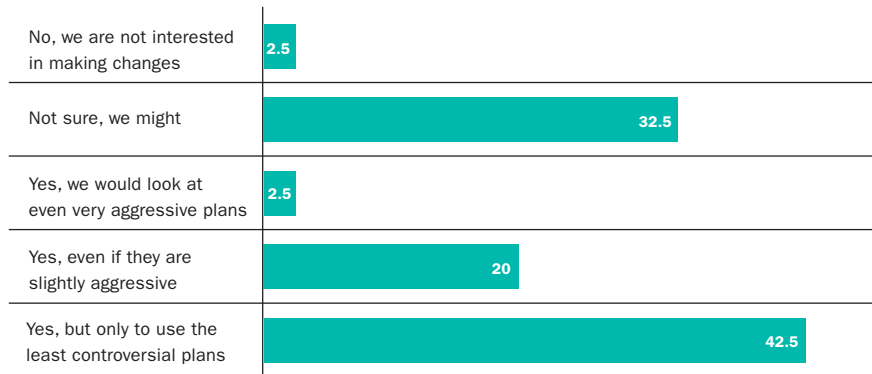
- unfunded pension promises (UURBS), including those backed with security
- offshore funded (FURBS) plans
- employee benefit trusts – with family sub-funds.

Summary

You need to start thinking about these issues now, as you may be hiring new executives or terminating the employment of current ones. Similarly, your executives will expect their next award of shares to be made more tax efficient if possible since the new tax rules will apply before it vests and any new share plan will have to meet the relentless AGM planning cycle.

sue.bartlett@towerswatson.com
calvin.jackson@towerswatson.com

Figure 7. Do you expect that your company will make changes to its long-term incentives to make them more tax-efficient?



About Towers Watson

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.