

REMUNERATION, RISK & REWARD

HOW TO REWARD AND MOTIVATE DIRECTORS IN A DOWNTURN

A REPORT FROM HANSON GREEN



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Director Incentives in a Downturn

Introduction

Executive remuneration is difficult to get right at the best of times. Following the financial crisis, and in the midst of a severe recession, it is an even greater challenge.

The sharp collapse in share price values – between July 2008 and March 2009, the FTSE 100 index lost nearly half of its value – means that most long-term incentive schemes will pay out poorly, if at all, risking widespread de-motivation.

But investors are in no mood to allow re-pricing of incentive awards or the cancellation of existing schemes in favour of ones priced at a lower level. Indeed, the 2009 ‘season’ of annual general meetings was notable for the unprecedented levels of shareholder protest over pay.

At BP, 43% of shareholders failed to support the remuneration policy; at Pearson, 48%; Xstrata, 36%; Shell, 61%; Next 59%. Manifest, the corporate governance advisers, said that shareholder dissent over pay doubled in 2009 compared to the previous year.

Against this difficult background, it is appropriate to revisit some of the assumptions round executive and director pay, and to offer suggestions for improving the linkage between pay and performance. The financial crisis and recession also makes it important that the right reforms are identified and adopted soon – once the economy recovers and businesses begin to grow again, it will be easy for companies to revert to the established, though unsatisfactory, practices that currently exist.

The challenge

Nearly 15 years after Sir Richard Greenbury, then chairman of Marks & Spencer, carried out an extensive enquiry into how executive remuneration is set and disclosed, there remains widespread concern over the effectiveness of the system.

There is clear evidence from the 2009 'season' of shareholders' meetings that neither directors nor investors feel we have cracked the question of how we reward executives.

Even some company leaders appear to think the same way. Jeroen van der Veer, the outgoing chief executive of Royal Dutch Shell, called into question the whole concept of incentive pay, suggesting that managers are motivated more by meeting the challenge of the job than mere money. "You have to realise: if I had been paid 50 per cent more, I would not have done it better. If I had been paid 50 per cent less, then I would not have done it worse," he said. (Financial Times, June 9, 2009).

Mr van der Veer was also quoted saying: "If the whole of society in its generality thinks that the remuneration model is a problem, that does mean that you have to change."

Undoubtedly, public trust in the system appears to be at an all time low – certainly not helped, in the US at any rate, by the disconcerting sight of large US banks apparently repaying federal rescue funds early in order to avoid government-set limits on remuneration.

The pressure for substantial reform on both sides of the Atlantic looks irresistible. The question is: what reforms do we need?

Proposals for change

There are two challenges that need to be met if we are to restore trust in the executive remuneration regime:

- Developing packages that reflect the circumstances of individual companies
- Aligning rewards with genuine, long-term value creation

Current remuneration policies are too rigid, and are generally insensitive to the individual circumstances of the company. Boards and remuneration committees need greater flexibility to develop more bespoke reward structures.

As Sir Rob Margetts, chairman of Legal & General, argues on page 4, too many remuneration committees feel constrained by the need to adopt a pay structure that will win a vote in favour from institutional investors. Those companies that do seek to break the mould and offer a scheme specific to the needs of the business can quickly become a lightning rod for criticism – see the Cable & Wireless case study on page 6.

This situation chills innovation, and potentially leads to executives being given confused objectives.

The right model, as Sir Rob Margetts argues, is for the board as a whole to determine the appropriate key performance indicators for the business, and the timeframe over which performance should be measured. Once this is agreed, it is up to the remuneration committee to design the reward structure accordingly and explain their thinking to the board and to shareholders.

Such a move requires considerable commitment, not just from company boards, but institutional investors. Greater innovation and diversity of scheme design undoubtedly creates extra work for institutions, as they seek to analyse and judge the merits of individual schemes.

The second challenge is to devise tools that allow remuneration companies to re-consider earlier judgements.

In the current executive pay landscape, three years is regarded as 'long term,' but as the recent crisis has shown us, that is too short a period to determine whether a given strategy has created sustainable value or brought the company to its knees.

A remuneration regime that allows executives to enjoy substantial rewards while shareholders eventually suffer catastrophic loss of value is not tolerable, and appropriate tools should be devised that commit executives to hold performance-related awards well beyond the time they leave the company. Ideally, such awards should be stock-based so that directors' interests are truly aligned with those of shareholders.

A 'to do' list for remuneration committees

- Determine the model that is appropriate to the company, its sector, stage of development and strategic plans
- Have the courage to ignore peer pressure and abandon standardised plans
- Work with remuneration consultants on innovative, flexible schemes
- Tailor pay structures to KPIs agreed by the board
- Relate rewards to company-specific targets and report accordingly
- Break the linkage between base pay and bonuses
- Determine appropriate methodologies for clawing back incentive pay in cases where genuine long-term value was not created
- Engage with investors on why these terms are best for the company and therefore shareholders
- Offer a more company-specific narrative in the remuneration report, showing how the remuneration policy is aligned with the company's strategic goals

A Chairman's View

Sir Rob Margetts Chairman, Legal & General

I have spent 30 years in executive life and the last ten as a non-executive director and chairman, yet I have few quick solutions to the question of how to incentivise directors appropriately. Remuneration remains a tough and challenging subject, and I confess that my thinking remains incomplete.

With that in mind, I prefer to pose questions rather than offer answers. Executive pay is once again under intense scrutiny and I hope these questions may contribute to furthering the debate and building a consensus around possible reforms.

Is there too much standardisation in the design of remuneration packages?

We all operate in different businesses, yet companies adopt broadly similar structures. That may be because remuneration consultants have been successful in pushing a single model, or because a standard scheme is more likely to be nodded through by the 'governance police' within the institutional investment community. A typical large institution may have 700 companies in its equity portfolio so the scrutiny given to individual pay schemes can only be slight.

I believe those two problems can be overcome, however. The main obstacle to remuneration committees taking a more tailored, company-specific approach to pay is sheer lack of courage. Directors on remuneration committees know that if we opt for a standard design with appropriately benchmarked numbers, it will get past the governance police and prevent the company being marked out for special attention. The problem is that most remuneration committees are just not very brave.

Richard Laphorne at Cable & Wireless showed courage (see case study in this report) and the company's innovative pay scheme attracted substantial criticism. But the scheme was appropriate for the business at that stage of its history.

Standardisation makes no sense given the huge diversity of businesses. Companies have entirely different 'heartbeats' when it comes to assessing performance, depending on the sector, cyclical, size and maturity. Remuneration structures should reflect this diversity.

Let me provide a couple of examples. At BOC, which I chaired, we paid bonuses quarterly, because that was the appropriate timeframe to measure performance. By contrast, Anglo American, where I am a non-executive director, is a capital intensive company operating in a highly cyclical industry. It has a completely different 'heartbeat', and to evaluate performance at Anglo American on a quarterly basis would be quite out of place.

Are we asking remuneration committees to do too much?

Again, the answer must be yes. I view the remuneration committee as more difficult and pressured than the audit committee, and have always preferred my most senior independent director to chair it.

There is an important distinction to be drawn between the role of the remuneration committee and that of the board as a whole, and it is important that the board recognises its role in supporting this vital committee. It should be the board's job to determine the key performance indicators of the business, judge the appropriate monitoring period and decide what represents satisfactory, good and exceptional performance.

It is then up to the remuneration committee to design a structure and individual packages that incentivise those outcomes, and to administer the execution of the scheme.

In too many situations, the remuneration committee finds itself taking on the board's responsibility for deciding the appropriate KPIs, which is a mistake. A strong chairman and effective board will support the remuneration committee by giving it the right direction and responsibilities.

Are we paying too much?

Opinions will vary on this point, but what is undeniable is that we are insufficiently discriminating in terms of defining good and exceptional performance as it applies to different companies in varied situations.

Disclosure and transparency are important elements of the executive remuneration regime, but they have created their own problems. The high level of disclosure means that executives have a tendency to view their pay in a relative rather than an absolute way. Managers should be motivated by what is going on in their company, the contribution they can make and the rewards that they can earn, rather than what their peers are earning. This relative view of the world has also helped foster an unhealthy attitude of greed.

Remuneration committees also need to understand how pay structure can affect behaviour and corporate culture. For example, does the board wish to reward teamwork or individuality? The structure of rewards can have a powerful impact on how employees interact and do business. Lastly, committees must be sure that the behaviours they are encouraging are aligned with shareholders' interests.

Boards should also be aware of the signals that pay decisions can send beyond the company. I have a basic philosophical problem with paying substantial management bonuses when the company as a whole is bearing the pain of redundancies, or when dividends are cancelled. Prescriptive, 'by the numbers' pay plans allow remuneration committees too little discretion in wrestling with these difficult questions.

Should we claw back incentive payments?

I am generally against clawbacks but I think there is a case for deferring a greater proportion (say, half or more) of executive bonuses into shares. The deferral period should then be sufficiently long to allow the remuneration committee to reach a considered judgement about whether genuine value has been created.

Excessive risk-taking can provide some short-term gains but, as we have seen, will eventually destroy significant value. Remuneration committees need tools to review earlier judgements in the light of subsequent events. Adding some measure of conditionality on the release of incentive awards is the right way to go, in my view.

Should performance measurement focus on input or output measures?

The answer to this question is different for every business. In some companies, long term value is created as a result of a series of inputs. For example, the capital allocation decisions made in an upstream energy business may not deliver returns for 20-25 years, so managers should be incentivised to put those investments in place. In other sectors, such as retail, the relevant performance measures will be tied to the outputs achieved. As discussed, remuneration committees need to decide what metrics are relevant to them and communicate their decisions to shareholders.

Are we clear about the purpose of each part of our remuneration structure?

Remuneration structure has become increasingly complicated, and not necessarily for good reasons. A senior manager is typically paid a salary and annual bonus, and is included in a long-term incentive plan. On top, there may be pension contributions and other benefits.

Are we clear about the specific function of each particular element?

There are various objectives we are trying to achieve with remuneration, including compensating individuals, aligning their interests with shareholders, retention, and incentivising future performance, but it is not always clear that the structures we have meets these objectives.

Sir Rob's contribution has been drawn from a speech given at a recent seminar on director incentives, co-hosted by Hanson Green and Ashurst, the international law firm.

Case Study

Cable & Wireless

In January 2003, Richard Lapthorne joined Cable & Wireless, the telecoms group, as chairman. The company was in trouble – the share price stood at 47p, compared to more than £15 three years earlier, wiping some £36 billion off the value of the company.

The company was widely viewed as a candidate for a takeover, breakup or a take-private transaction, and appeared to have a short future as a publicly quoted company. Lapthorne proceeded to change the company's management and re-organise its assets and structure. This culminated in the decision to clearly delineate the company into two operating businesses, CWI and Worldwide, with a small central team acting as a portfolio manager of the two. As part of the restructuring, the board unveiled an innovative remuneration plan (LTIP) in 2006 that offered substantial rewards to senior managers but only for delivering exceptional returns to shareholders.

The plan contained elements of remuneration strategies used in private equity situations, applying them to the conditions of a public company. The detailed plan was explained in a 9-page letter to shareholders which emphasised that the aim of the plan was to effect a turnaround in the business and maximise returns to shareholders. The plan put a valuation on each of Cable & Wireless's two business units, based on the overall market cap of the group – Worldwide was valued at £536m and CWI at £2.041 billion.

It incentivised the 60 participating senior managers to increase the value of the business they worked in over the four year life of the plan. Each business would have to achieve earnings that met an "LTIP hurdle rate", set by the board and based on their cost of capital (the interest rate at which each business could borrow). Participating managers would be entitled to 10% of any increase, above the LTIP hurdle, in the value of the business they worked in.

The increases in the value of each business would be measured by the overall market capitalisation of Cable & Wireless Group – hence aligning managers' interests with shareholders' – as well as other factors. Business values would also be affected by how much cash flow each business was able to generate for the group. Cash that was "repatriated" to the group company was added to their business values, while any cash outflow would be deducted from the values.

The reward pool was divided among managers on the basis of seniority. John Pluthero, the executive chairman of the Worldwide business and, for a period, also the executive chairman of the CWI business, received the most headlines for his potential to earn more than £20m, if the company's share price doubled over the four years of the scheme. He told the press: "I don't make any money unless our shareholders make a whole lot more." (Times, Nov 14, 2007).

In seeking investor approval for the plan, Cable & Wireless offered some concessions, such as freezing salaries for three years, capping individual rewards at £20m, reducing bonuses and requiring directors to hold at least two times their annual salary in Cable & Wireless shares.

Finally, the administration of the scheme was to be independently audited by PricewaterhouseCoopers, which was not the company's appointed auditor.

Some shareholders expressed scepticism about the plan in 2006 and at the company's annual general meeting 14% of shareholders voted against the scheme. One investor said: "Many shareholders have a lot of problems with it. It's the scale of it, it's all upside and no downside. They are not putting any of their own money in and the rewards are out of kilter."

Other commentators, however, saw the plan as part of a bold effort to revive the company and maximise value for its long-suffering shareholders. John Waples, writing in the Sunday Times, said: "Cable & Wireless's corporate meltdown is not the fault of the current management team ... by proposing an innovative private

equity-style bonus package, Laphorne is sending out a strong message that the company has a future.” (Sunday Times, May 14 2006).

In the year after the plan was introduced, Cable & Wireless’s share price performed strongly, rising 72% and adding £2.5bn to the group’s market capitalisation. As a result, the company sought investor permission to lift the £20m cap on individual payments, but with the condition that any amount above £20m was paid in shares. At the same time, the board introduced an incentive scheme for Richard Laphorne under which he was awarded 5.5m performance shares, which vested only if the company delivered on stretching performance targets over the following 3 years.

The chairman’s award was controversial – under UK governance guidelines, chairmen are typically non-executive and therefore do not participate in incentive schemes. However, Cable & Wireless’s structure means it does not have a group chief executive, but instead has individual heads of its two business units. This means that Laphorne’s role requires a greater time commitment than that of most chairmen. Laphorne agreed to give up any salary increases or other cash bonuses over the life of the scheme and to face annual re-election at the AGM. At the 2007 annual meeting about 10% of shareholder votes were against the removal of the £20m cap on the LTIP payment, and about 9% against the remuneration report.

At the July 2007 annual meeting, Laphorne told investors: “A lot of articles suggest that I’d been given £10m of shares – I wish it was true. I don’t feel this is cattish. I feel this is damn hard work.” He pointed out that, based on market conditions at the time, he would only get the full allocation of 5.5m shares if the share price hits 370p, which would be equivalent to a £4.6bn increase in Cable & Wireless’s share value, equivalent to a near doubling of the company’s market capitalisation.

In 2009, Cable & Wireless proposed a further change, seeking a one year extension to the plan on the basis that the credit crisis had delayed the company’s strategic plans for value realisation, and outlined plans for making an orderly transition to a more conventional long-term incentive plan thereafter. The extension would mean the payments to executives on the plan would be made in three instalments instead of two, and therefore reduced the size of the first two payments. It consulted its major shareholders on the changes, and amended its plan based on their feedback. It agreed to extend the salary freeze for executive directors for a fourth year, to limit annual bonuses to below market levels and to increase the requirement for directors shareholding to at least four times their salaries.

In a letter to shareholders, Cable & Wireless spelled out how the company had performed in the three years since the scheme was introduced. Richard Laphorne said: “Since the LTIP was introduced, we have been the fifth best performer in the FTSE 100 in terms of total shareholder return and the second best performer in the FTSE Global Telecoms Sector Index, creating £1.1 billion of positive shareholder value.” He noted that Cable & Wireless’s shares had gained 44% in the period, compared to a fall in the FTSE 100 index of 26%.

As Richard Laphorne said: “Through a combination of share based incentives arrangements and the proposed one year extension of the LTIP, we believe we have the best structure to ensure that we both keep our talented team and ensure that they continue to drive hard to create further value for shareholders.”

Following the announcement, the LTIP paid out its first instalment to executives in May 2009. Over the first three years of the plan Worldwide had created £622m of ‘extraordinary’ shareholder value (ie: above the hurdle) and CWI £83m – resulting in pots of £62.2m for Worlwide executives and £8.3m for CWI. In the first instalment executives were entitled to only 67% of each pot, with the remaining 33% to be paid out over the following two years. For his part in delivering this performance, John Pluthero earned £8.3m from the 2009 payout, equivalent to an incentive award of £2.7m per year over the three year course of the plan to that date.

Kate Nealon, a Cable & Wireless non-executive director and chair of the Board’s remuneration committee commented on the remuneration plans: “Throughout my three years as Chair of the Remuneration Committee at Cable & Wireless our main goal has been to develop reward policies which support the generation of extraordinary shareholder value. I am very pleased that the business performance – second best performer global telecom over the first three years of the plan – has fully justified the radical approach we adopted and allowed us to retain strong management teams in our business.”

About Hanson Green

A member of the Directorbank Group, we are a specialist search firm with a market-leading position in the appointment of chairmen and non-executive directors. We also offer a specialist board evaluation practice as well as an executive search practice for financial services appointments.

Our proven track record of solving clients' recruitment challenges, combined with the unrivalled quality of our service has made us the search partner of choice for a wide range of FTSE and AIM quoted companies based in the UK and overseas.

Founded in 1989, we were a pioneer in identifying the need for professionally-appointed non-executive directors and have been a key contributor to the ongoing debate on corporate governance best practice ever since. We co-founded the Henley Centre for Board Effectiveness and have worked with Cass and Warwick Business Schools on corporate governance thought leadership.





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