Observations and Commentary on Current Institutional Attitudes to Executive Pay

Background

The current difficult economic conditions present a number of challenges to remuneration committees. Ensuring that executives remain appropriately incentivised and rewarded for guiding companies through what will be for many extremely tough times whilst ensuring that the interests of shareholders are adequately considered will be a fine balancing act.

Dialogue with key shareholders is critical and a clear case will need to be made for any changes that are made to executive remuneration, especially if it is felt necessary to adjust downwards targets for short and long term incentives or to suggest structures contrary to the combined code or institutional investors' guidelines.

The recent example of Bellway, where nearly 60% of shareholders voted against the remuneration report at the AGM, highlights the dangers of failing to consult with key shareholders. Prior to the vote the ABI had placed a 'red top' on the company's remuneration report due to the fact that the original performance criteria had been disregarded by the Remuneration Committee in making decisions on the level of annual bonuses paid to executives for performance in 2008.

In addition, the remuneration report attracted concern from PIRC over the decision to adopt a more discretionary approach to annual bonuses for 2009 with no specific performance conditions set at the start of the year.

These decisions had been taken based on the view that the current economic climate represented 'genuinely exceptional circumstances' for Bellway and the house building sector in general. Consequently it was felt that 2008 annual bonuses should be based on the company's overall performance both in its own right and in comparison to others in the sector and that the 'short-term lack of visibility in the outlook for financial performance' made it necessary to adopt 'a less formulaic bonus structure' for 2009.

Many other remuneration committees will be facing very similar issues concerning existing and future incentive arrangements in particular in relation to:

- the relaxation of performance conditions for existing short and long term incentive plans and
- the size of awards to be made for 2009 short and long term incentives and the setting of appropriate performance conditions.

MM & K have had discussions with some of the main institutional investors on these issues and we have outlined below what we understand to be their views.

Relaxing performance conditions on existing incentive plans

Whilst it is typical for incentive plan rules to allow remuneration committees discretion to change performance conditions on existing incentive plans in exceptional circumstances, the view of the institutions is that the current downturn does not necessarily constitute "exceptional circumstances". As such all are opposed, in general, to the resetting of performance conditions on existing incentive arrangements.

Even so, the majority of institutional investors do seem to accept that there may be some cases in which the resetting of targets may be appropriate.

Both the ABI and Schroders have said that they may accept that, in some cases, it will be appropriate to review the performance conditions attached to existing incentive schemes. However, they were very clear that companies should speak to key shareholders in advance of making any such decision and that a compelling case needs to be made over and above the current tougher economic climate.

In contrast, Aviva Investors would appear to be taking a much harder line on this issue. In a recent communication sent out by their Regional Head of Corporate Governance the retrospective changing of performance targets was described very simply as 'unacceptable'.

The general view of institutions would seem to be that the preferred way of "dealing with" unachievable performance criteria applying to outstanding bonus or LTIP Awards is the granting of new awards, looking forward, with achievable targets. Much store is set in the principle that Long Term Incentive Plans should have phased annual grants and whilst perhaps the last two grants will never pay out, ones granted now should be able to create sufficient incentive going forward.

Size of awards and performance conditions for future incentive plans

The structuring of future incentive plans would seem to be an area in which the institutions will allow greater flexibility. However, there are a range of views on what is appropriate.

The view of the institutions would seem to be that a significant proportion of remuneration should remain linked to performance. Whilst it would seem to be accepted by institutions that lower performance targets may be necessary both the ABI and Aviva Investors have expressed the view that this should combined with lower potential rewards for meeting these targets.

On this subject Aviva Investors have stated:
'Just as companies argued for increased quanta in the good times and when targets were increased, reduced targets should mean reduced quanta'.

More specifically on the subject of share based incentive schemes, both the ABI and Aviva Investors have expressed the view that for companies where the share price has dropped significantly in recent months, this should be taken into account when determining the number of shares granted under future awards rather than granting a number of shares linked directly to a percentage of salary.

In a letter to Chairmen of Remuneration Committees dated 19 September 2008 the ABI stated that:
'Where a company has underperformed and seen a significant fall in its share price, this should be taken into account when determining the level of awards under share incentive schemes. In such circumstances, it is not appropriate for executives to receive awards of such a size that they are perceived as rewards for failure.'

In a similar vein Aviva Investors have stated:
'Indeed, in the current situation real care and thought is needed on the number of shares used in share scheme grants. As a starting point, remuneration committees should ask themselves whether any increase in the number of shares covered by grants is really warranted? Restraint would be aligned with the shareholders' position and will avoid creating a pay bubble built off current low prices.'

This is, however, by no means a universal view. Schroders for example, whilst acknowledging that remuneration committees need to be sensitive to this issue, have expressed the view that the granting of greater numbers of shares is not unreasonable in creating an appropriate incentive to executives managing businesses through these difficult times just as investors accepted as reasonable the fact that executives would receive grants over fewer shares in rising markets.

Schroders have, in the past, advocated annual awards based on a fixed number of shares, in effect creating an additional incentive if the share price increases. This would be very similar to the approach taken by many private companies to share incentives, where it is more typical for an agreed proportion of the share capital of the company to be awarded to executives but linked to absolute rather than relative performance measures.

The challenges facing Remuneration Committees

It is clear that the many Remuneration Committees will face difficult decisions in the coming months and must ensure that the remuneration structures in place provide a suitable mechanism for retaining and motivating executives whilst acknowledging and addressing the concerns of shareholders.

Our discussions would suggest that there is scope for flexibility in the approach adopted by companies but that a dialogue will need to be maintained with key shareholders and a clear and strong case made for any changes, and in particular any relaxation of performance criteria.

If this dialogue does not happen there are very real dangers of shareholder revolts with resulting damage to corporate reputations.

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