

Executive remuneration trends in Switzerland

Challenges and opportunities in the Swiss executive compensation landscape

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This article comments on two key developments and challenges in the executive remuneration landscape in Switzerland (and in other countries).

First, finding the right quantum of compensation remains challenging for boards. Also, while pay-for-performance discussions in annual reports have improved, there is still some level of dissatisfaction among shareholders. This provides competitive opportunities for companies. Second, simplifying pay design while retaining appropriate incentives is another big challenge. We propose one simple, yet effective system for achieving this goal. In the outlook, we also note that shareholders are increasingly interested in having a link of compensation to 'corporate social responsibility' issues.

Challenge and opportunity 1: Levels of compensation and the pay-performance-link

One of the perennial challenges for boards is to set the right quantum of compensation. While ultimately every board has to decide what is right for their company, a broad view of the market can help assess the attractiveness of a pay package offered. Although the structure of pay does affect the value of any given expected level of pay due to different risk characteristics of different compensation structures, the overall level – and its link to performance – still receives significant attention.

To begin, and for context, consider first some key facts for the largest 100 listed Swiss companies. These consist of the 20 SMI companies, the roughly 30 SMIM companies and the roughly 50 small-cap companies. We have data since 2007, but we typically use 2009, the first post-crisis

year, as a comparison point. The 2019 data is not publicly released by companies yet, so we refer to 2018 compensation data in this article (See Figure 1, right).

First, the total sum of executive compensation in the largest 100 Swiss companies in 2018 was about CHF1.3billion, slightly below the sum in 2009. Thus, executive compensation is a sizable component of company expenses. Interestingly, there has been a shift among companies. The total sum paid to the SMI executives in 2018 was CHF709million (-15 per cent since 2009); the aggregate sum paid to the SMIM executives was CHF300million (+/- zero per cent); the sum paid to small-cap executives was CHF306million (+22 per cent).

Second, median compensation levels have gone up (suggesting that any fall or stability in compensation on the aggregate level is due to a decrease of the highest amounts). In particular, in 2018, the median SMI firm spent CHF30.4million on executive compensation (+13 per cent since 2009), the median SMIM firm CHF11.8million (+13 per cent) and the median small-cap firm CHF5.7million (+32 per cent). Similarly, compensation of the median CEO in 2018 was substantially higher than in 2009 in all three groups of companies. The median CEOs of SMI, SMIM and small-cap companies in 2018 received CHF6.5million (+18 per cent), CHF3.2million (+49 per cent) and CHF1.4million (+16 per cent), respectively. The median CEO of an SMI company thus received around two times the pay of his or her counterpart in an SMIM company (down from 2.6 times in 2009). The median CEO of an SMIM company received around 2.2 times the pay of his or her counterpart in a small-cap company (up from 1.8 times in 2009). See Figure 1, right.

Third, what about pay-for-performance? On the data through 2017, when in a given year a Swiss company achieves a total shareholder return (TSR) in the top tercile of TSRs in the same industry in that year, variable CEO compensation disclosed as given for that performance year increases relative to the previous year by around 9.5

per cent at the median. In the bottom tercile of industry-adjusted share performance, variable CEO compensation falls by around 3.8 per cent compared with the previous year. Indirect effects can be more significant: companies are more likely to change their CEO when performance is lower. Specifically, in the top tercile of relative TSR, the probability of a CEO turnover is around 14 per cent; in the bottom tercile, it is around 21 per cent. Because after a turnover due to poor performance, CEOs tend to work at smaller companies (if at all), a strong board can induce substantial implicit pay-for-performance. This effect (which economists refer to as 'career concerns') can, thus, also create ex-ante incentives for strong performance.

Fourth, even where a pay-for-performance link exists, shareholders are sometimes not clear on it. A survey conducted by SWIPRA shows that out of around 80 large institutional investors (asset managers and pension funds) not a single one said in 2019 that they were 'very satisfied' with the comprehensibility of pay for performance reporting of Swiss issuers. There is some good news: the fraction of explicitly 'dissatisfied' investors has fallen from more than 50 per cent in 2016 to around 25 per cent in 2019. Still, there remains work to be done. Indeed, this also presents an opportunity for companies to differentiate themselves from their competitors. Also, recent research demonstrates that higher quality value reporting to the outside supports better decision-making inside the company.²

IMPORTANCE OF PAY
Executive compensation is a sizable component of a company's expenses

The concerns with complexity and poorly understood incentives are perhaps most visible in the context of equity-based compensation. Stock Awards for Right Strategy (STARS) provide a simple, transparent alternative

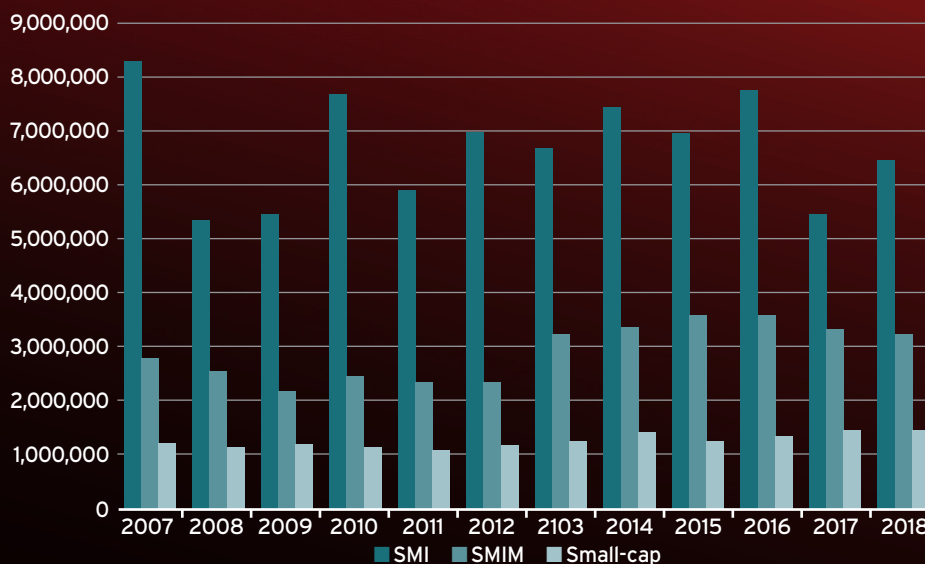
Challenge and opportunity 2: Making equity-based pay work

Many compensation systems are extremely complex. When a reward system becomes intractable for stakeholders and dysfunctional for the very people it is supposed to incentivise, it is time to rethink and redesign. Indeed, many large shareholders have also become critical of complex compensation systems.

The concerns with complexity and poorly understood incentives are perhaps most visible in the context of equity-based compensation. One popular vehicle for

share-based remuneration is performance stock units (PSUs). These consist of the right to be allocated shares in the future if the executive (a) remains with the company (service condition) over a period of multiple years and (b) meets the defined targets over a specific performance period (performance condition). The performance criteria often comprise total shareholder return or earnings per share measured (or a combination) over a period of three to four years. Each PSU unit typically not only gives the right to be allocated one share at vesting, but normally comes with an additional lever, increasing the factor to two or even 2.5 shares per unit if targets are exceeded. Conversely, if minimum targets are not met, zero shares will be allocated. Importantly, in terms of the payout profile, PSUs are similar to stock options: In the best case, managers participate disproportionately in the increase of the share price; and as is the case with an option, there is the risk that the manager never receives any payout from their rights if the threshold is not met. The board must undertake a comprehensive critical analysis to decide whether such a leveraged and complex instrument is in line with the company strategy and the risk appetite. »

FIGURE 1: MEDIAN CEO TOTAL COMPENSATION (IN CHF) IN THE 100 LARGEST SWISS LISTED COMPANIES

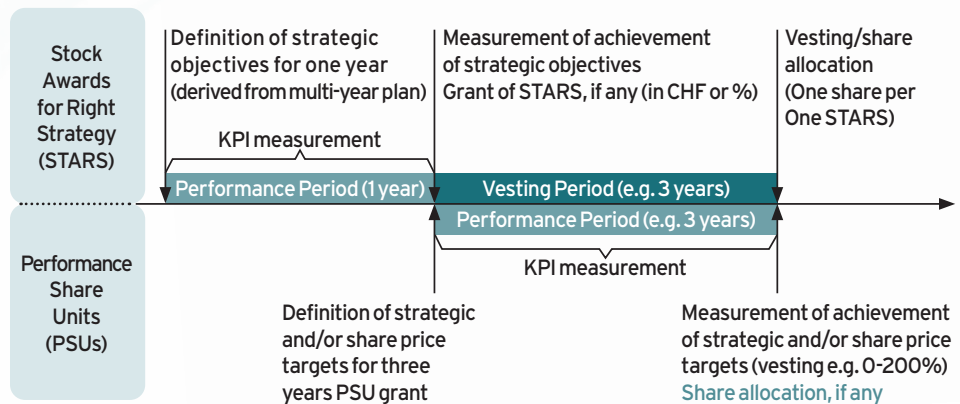


» We have recently developed a new remuneration approach, which we call Stock Awards for Right Strategy (STARS). This proposal uses shares to reward past target achievements that are strategically relevant. Figure 2, right illustrates the typical process over time and contrasts it with PSUs. There is nothing new as such in giving a bonus in the form of shares. However, the key points about the system presented here are, first, the specific alignment of remuneration targets with the company's strategic objectives and, second, the consideration of the changes of the manager's equity over time (wealth lever).

First, STARS put the board's role of leading the company into the future in the spotlight. The strategic objectives that underpin STARS must be tailored to the company's specific business model. The specific set of performance indicators that best documents the achievement of strategic (interim) objectives must depend on the company's individual situation. STARS do not dictate best practice for the targets. For example, a board may come to the conclusion that digitalisation is a key topic for the company. This could result in corresponding, specific one-year targets (milestones) being defined. Ultimately, this aspect will also feed into cash flow and then into the share price. However, a board must be able to specify a clear strategic vision of the company with corresponding strategic objectives and should reward management for their achievements in execution even if these efforts are not rewarded by the stock market in the short or even medium term. This requires a (sometimes tricky) balancing act. The board and the management must not remove themselves completely from the needs of the shareholders. Nevertheless, it seems to us essential that courageous boards pursue the strategic objectives for their companies and underpin as well as reinforce these with suitable remuneration systems.

Second, if STARS are used consistently over time, managers may build up substantial share positions over the years.³ Owing to the wealth impact on the managers' shares (or shares to be allocated in the future), the management perceives changes in business development in terms of the change in the equity value of the company. Especially when managers hold substantial share positions, these value fluctuations can be significant. It is, therefore, essential that these changes in

FIGURE 2: CONTRASTING STARS AND PSUs



equity value are also reflected in the remuneration discussion and assessment

Additional factors play a role. First, there are situations in which an excessive focus on equity is not suitable. Highly indebted companies may do well to use 'inside debt', i.e. to incentivise managers to take account of the position of creditors directly (and not only indirectly via the value of equity). Second, regulatory frameworks can also limit the design opportunities, which is particularly applicable in the case of financial sector companies. Third, this discussion sets aside tax law aspects. Still, we hope that as a basic design choice, many companies will see the merits of STARS going forward.

Executive remuneration is a key factor by which effective boards can distinguish themselves from uninspired, mediocre "best practice" followers

Concluding remarks: corporate social responsibility and compensation design

For a long time, corporate social responsibility (CSR) was a topic for executive remuneration mostly as a risk factor. Companies and managers with poorly calibrated compensation systems faced 'headline risk'. More recently, CSR itself has become a key design element for compensation. Indeed, a survey conducted by SWIPRA in 2019 revealed that 78.9 per cent of investors consider CSR targets in compensation systems as key to long-term sustainability. Importantly, while the discussion of whether the share price already reflects CSR considerations (as it perhaps should, from a theoretical perspective) is interesting academically, it appears somewhat moot when considering the survey result: 35.3 per cent of the issuers believe that CSR performance is reflected sufficiently in financial performance and only 17.6 per cent of the investors agree with this statement. Recent

research also highlights that the ESG triad – consisting of environmental (E) and social (S) performance, not only governance (G) aspects – is highly relevant for shareholders. Overall, companies would, therefore, do well to find ways of explicitly incorporating CSR and ESG criteria into their compensation systems.

How can companies avoid the traditional concern with such measures, namely, that they can be abused by poorly performing management to claim valuable contributions to society and broader goals while destroying shareholder value? One way is to link them to STARS, as described in the prior section. Under such a system, ESG and CSR performance is not juxtaposed with shareholder performance but is fundamentally and positively connected with it in the long run.

In summary, the topic of executive remuneration remains highly controversial. More importantly, seen as an opportunity, it remains a key factor by which effective boards can distinguish themselves from uninspired, mediocre 'best practice' followers. A rational and long-term focussed remuneration system is a necessary, rather than a sufficient condition for value-generating corporate governance. The board and executives together must take a holistic view that tightly links the design of the remuneration system, the composition of the board and the executive/shareholder engagement and value reporting. 🌐

¹For details, we refer to the PwC Insights 2017, available at: <https://www.pwc.ch/en/insights/hr/exco-insights/exco-insights-2017.html> ²See Eugster and Wagner, 2019, 'Value Reporting and Firm Performance', Journal of International Accounting, Auditing and Taxation, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1879804 ³The figure suggests that STARS are earned over a period of three years (for example) after grant. This means that the share allocation occurs only at the end of the (vesting) period in the case of an active employment relationship. This makes sense in view of the desired long-term orientation of the managers. However, it is also possible to allocate blocked or unblocked shares immediately to the management as long as they are required to build up and hold a defined number or defined value in shares of their own company.