Executive Compensation & Corporate Governance

2009 survey examining compensation structure in SMI and SMIM companies as well as an analysis of pay-for-performance for CEOs
<table>
<thead>
<tr>
<th>Description</th>
<th>2007</th>
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<th>Changes</th>
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<th>2008</th>
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<tbody>
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<td>Chairman SMI SMIM</td>
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<td>15,228,951</td>
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<td>932,560</td>
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<td>430,500</td>
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<td>0.0%</td>
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<table>
<thead>
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<th>2008</th>
<th>Changes</th>
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<td>5,027,381</td>
<td>2,901,796</td>
<td>–42.3%</td>
<td>3,255,621</td>
<td>4,107,000</td>
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<tr>
<td>Upper quartile</td>
<td>400,000</td>
<td>375,053</td>
<td>–6.2%</td>
<td>221,000</td>
<td>218,217</td>
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<tr>
<td>Median</td>
<td>296,030</td>
<td>279,869</td>
<td>–5.5%</td>
<td>169,000</td>
<td>154,500</td>
<td>–8.6%</td>
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<tr>
<td>Lower quartile</td>
<td>176,265</td>
<td>170,000</td>
<td>–3.6%</td>
<td>105,919</td>
<td>106,250</td>
<td>+0.3%</td>
</tr>
<tr>
<td>Lowest</td>
<td>0</td>
<td>0</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>2007</th>
<th>2008</th>
<th>Changes</th>
<th>2007</th>
<th>2008</th>
<th>Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest</td>
<td>22,280,000</td>
<td>20,544,032</td>
<td>–7.8%</td>
<td>12,024,884</td>
<td>7,062,808</td>
<td>–41.3%</td>
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<tr>
<td>Upper quartile</td>
<td>12,618,250</td>
<td>8,185,720</td>
<td>–35.1%</td>
<td>4,058,039</td>
<td>3,469,390</td>
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</tr>
<tr>
<td>Median</td>
<td>7,727,944</td>
<td>5,351,799</td>
<td>–30.8%</td>
<td>2,750,174</td>
<td>2,520,853</td>
<td>–8.3%</td>
</tr>
<tr>
<td>Lower quartile</td>
<td>4,792,787</td>
<td>3,770,484</td>
<td>–21.3%</td>
<td>1,788,900</td>
<td>1,581,127</td>
<td>–11.6%</td>
</tr>
<tr>
<td>Lowest</td>
<td>1,704,000</td>
<td>1,814,702</td>
<td>6.5%</td>
<td>1,012,836</td>
<td>930,824</td>
<td>–8.1%</td>
</tr>
</tbody>
</table>
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1 The Survey

This is the third edition of the “Executive Compensation & Corporate Governance” survey by PricewaterhouseCoopers (PwC) in Switzerland. This survey includes an analysis of publicly available executive compensation data of the 20 SMI companies as well as 28 companies of the SMIM index.

The survey focuses on the level and structure of executive compensation in 2008, including a comparison with 2007. This is complemented by an analysis of how CEO compensation is linked to performance in the companies surveyed.

All data used in this survey is based on disclosed compensation information in the annual reports 2008 of the companies reviewed. We have not made any assumptions or adjustments to the disclosed values and methodologies used, in particular with regard to the variable compensation (valuation, vesting clauses, timing of disclosure and earning periods, etc.).

This report provides a comprehensive picture of executive compensation for SMI and SMIM companies in Switzerland today, and we hope you find this additional breadth of perspective helpful. As always, we welcome your feedback and hope to have the opportunity to debate these issues with you.

Dr. Robert W. Kuipers
Partner
HRS Consulting

Remo Schmid
Partner
HRS Consulting
2 Executive Summary

The dramatic change in the economic climate put a spotlight on executive compensation. However, compensation cannot be blamed as the main cause for the crisis. A number of other factors such as high expectations of shareholders, corporate cultures encouraging excessive risk taking and inadequate regulatory frameworks played a key role as well.

Building on last year’s survey, the 2009 issue of “Executive Compensation & Corporate Governance” examines the changes from 2007 to 2008 in total compensation for the board of directors and CEOs. The key findings are:

- The median total compensation for the chairman in SMI companies dropped by 29.6% to CHF 844,723. At the same time, median total compensation for the chairman in SMIM companies rose by 35.2% to CHF 581,876.

- For the CEOs, median total compensation dropped in both SMI and SMIM companies by 30.8% to CHF 5.4 million and 8.3% to CHF 2.5 million, respectively.

- The average CEO compensation decreased by approximately 25% to CHF 6.9 million in SMI companies and to CHF 2.9 million in SMIM companies. This reduction was caused by a decline in variable compensation: In SMI companies, the cash bonus dropped by 50%. In SMIM companies, the long-term incentives decreased by 50%.

- As a consequence of plummeting share prices, some members of boards of directors and the executive boards suffered significant losses in wealth on their company shares. For instance, the average wealth loss of the CEOs amounted to CHF 9.5 million. The distribution is skewed, though: the median wealth loss was CHF 1 million.

In this survey, we also considered the performance sensitivity of CEO pay. We analysed the relationship between total shareholder return (TSR) and total compensation as well as wealth changes based on share ownership: For every CHF 1,000 change in shareholder value in the past and current year together, the median CEO is affected by CHF 0.80. This consists of a change of CHF 0.50 in direct compensation and CHF 0.30 in share ownership. Overall, these initial results suggest that there is a positive correlation between pay and performance. With more data over the coming years, we will see with increased precision if shareholders indeed get performance for pay.

Now is the time to review compensation systems, in particular in the light of the anticipated regulatory changes. Prerequisites for a successful total compensation system are good corporate governance and a strong and independent board of directors.
3 Focus Areas of the Survey

The compensation of top executives has been a topic of public debate and media attention for some time now. But with the advent of the economic crisis, the political debate on compensation systems has become increasingly heated. Even so, compensation can hardly be blamed as the main cause of the economic crisis. In truth, it has been like a catalyst that has exacerbated inadequacies in strategy, risk management and corporate culture. The real problem has lain in some companies in the interplay of a corporate culture encouraging excessive risk taking, a lack of far-sightedness and weak corporate governance. High expectations of investors, excessive trust in economic and financial models, inadequate regulatory frameworks and behaviour of some individuals provided the backdrop for these company-internal problems to spread so broadly.

3.1 Level and structure of total compensation

The main target of public criticism is the amount of compensation for top executives. While this may provide some grounds for scrutiny, it is only one angle of looking at executive compensation. More important than that, however, is the structure and the combination of the different elements of total compensation. The graph below shows the five elements of total compensation and the respective key considerations.

In section 4.1 of this survey, we examine the structure and level of total compensation for both boards of directors and executive boards for SMI and SMIM companies.

Figure 1: Elements of total compensation

- Participation in the long-term sustainable value creation (prospective view)
- Alignment of interests of shareholders and management through ownership (holding guidelines)
- Enforcement of corporate culture and business strategy
- Short-term retrospective performance measurement (quantitative and qualitative goals)
- Risk adjustment and use of non-financial metrics
- Deferred mechanism and bonus bank to enforce sustainability
- Fixed compensation element, representing market value of function
- Functional grading system (e.g. STRATA) serving as basis for total compensation system
- Increasing focus on base salary
- Important remuneration element (long-term wealth accumulation)
- Social security planning and compliance
- Pressure on funding of liabilities (asset performance and ageing of society)
- Tailored and tax-efficient offering
- Cost control
3.2 Pay-for-performance

Total compensation must support the business strategy and long-term value generation and effective compensation systems tie managerial pay to performance. Of course, pay-for-performance is not a guarantee for better performance, but it is one factor in a best-practice total compensation strategy.

As shown in Figure 1, total compensation comprises various elements. For top executives, the variable part of total compensation is significantly higher than the fixed part. It is, therefore, important to identify the right performance metrics and to set the goals appropriately, supporting the long-term business strategy.

The right reward system for a particular company depends directly on its business strategy and the environment in which it operates. There is no such thing as an ideal system to fit all companies – not even in a single industry. Therefore, tailoring the reward system in a “best fit” approach is a key factor.

Section 4.2 focuses on the relationship between pay and performance for SMI and SMIM CEOs.

3.3 Corporate governance and compensation committees

Good corporate governance directly depends on a strong board of directors that assumes its oversight role of the company by ultimately driving the culture and setting the standards for behaviour throughout the organisation.

Compensation systems are a mirror of corporate culture and governance and have to be specific to individual organisations. Every organisation has to consider the challenge of finding the right personnel: managers who are able to implement strategy; people who do not just have the right professional qualifications, but who also set the right tone at the top.

Drawing up compensation systems should be at the very core of the responsibilities of the compensation committee, acting on behalf of and in close consultation with the full board of directors.

In section 5, we comment on the effectiveness of board of directors in practice and we report on some recent research on this topic.
4 Survey Results

For 2008, companies had to disclose detailed compensation information including, for the first time, a comparison to the previous year. This is a consequence of the Transparency Act which came into force in 2007. In this section, we analyse and comment on the level and structure of compensation as well as the link between pay and performance.

4.1 Level and structure of total compensation

The table below summarises the level of median total compensation in SMI and SMIM companies and changes from 2007 to 2008. The detailed figures are listed in the tables on the last page of this survey.

The graphs in this section illustrate some findings on the level and structure of compensation for boards of directors, CEOs, and other executives of the SMI and SMIM companies.

<table>
<thead>
<tr>
<th></th>
<th>SMI 2008</th>
<th>Change to previous year</th>
<th>SMIM 2008</th>
<th>Change to previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chairman</td>
<td>844,723</td>
<td>-29.6%</td>
<td>581,876</td>
<td>+35.2%</td>
</tr>
<tr>
<td>Other members of boards of directors</td>
<td>279,869</td>
<td>-5.5%</td>
<td>154,500</td>
<td>-8.6%</td>
</tr>
<tr>
<td>CEO</td>
<td>5,351,799</td>
<td>-30.8%</td>
<td>2,520,853</td>
<td>-8.3%</td>
</tr>
</tbody>
</table>

Table 1: Comparison of median total compensation in CHF
4.1.1 Chairman of the board of directors

As the structure of the board of directors and the related responsibilities and tasks for each member of the board of directors vary, for the chairman in particular, a one-to-one comparison among the SMI and SMIM companies proved difficult. Nevertheless, a comparison was made based on compensation data disclosed, whereby only the non-executive chairman function was considered.

SMI companies

In general, the total compensation for chairmen has decreased significantly from 2007 to 2008. The median, for instance, dropped by 29.6% from CHF 1.2 million to CHF 844,723. The lower quartile decreased by 23.7% to CHF 397,564 and the upper quartile decreased by 7.0% to CHF 2.4 million. In contrary, the highest amount disclosed increased by 4.1% to CHF 15.2 million. It has to be noted, though, that this individual case was an executive chairman in the previous year.

The findings above need to be put into context in the light of the difficult market situation and the economic circumstances. Furthermore, the FS industry, which forms a major part of the SMI, had to bear a heavy negative impact in 2008. This is mirrored in the reduced total compensation levels.

Figure 2: Total compensation of chairmen in SMI companies

![Figure 2: Total compensation of chairmen in SMI companies](image)

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1) Compensation for non-executive function (n = 18)
**SMIM companies**

For chairmen in the SMIM companies, the total compensation has generally increased. The median, for example, went up by 35.2% from CHF 430,500 to CHF 581,876 and the upper quartile increased by 2.9% to CHF 932,560. The lower quartile decreased by 6.4% to CHF 261,000 and the highest amount disclosed decreased by 30.2% to CHF 7.4 million.

Taking these observations together, we see that total compensation levels for SMIM chairmen have increased significantly while the levels for SMI chairmen have dropped considerably. For example, the median for SMIM companies amounts to CHF 581,876 (+35.2%), whereas for SMI companies, the median is CHF 844,723 (−29.6%). This suggests a possible convergence of total compensation for chairmen. It remains to be seen whether this trend continues over the coming years.

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**Figure 3: Total compensation of chairmen in SMIM companies**

![Bar chart showing total compensation of chairmen in SMIM companies](chart.png)

- **Lowest**
- **Lower quartile**
- **Median**
- **Upper quartile**
- **Highest**

---

2) Compensation for non-executive function (n = 26)
4.1.2 Other members of the board of directors

**SMI companies**

For other members of the board of directors, all amounts have decreased with the most significant drop in total compensation for the highest paid from CHF 5.0 million to CHF 2.9 million (–42.3%). The upper quartile decreased to CHF 375,053 (–6.2%), the median to CHF 279,869 (–5.5%) and the lower quartile to CHF 170,000 (–3.6%).

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Figure 4: Total compensation of other members of the board of directors in SMI companies

Chairman and executive functions excluded (n = 201)
**SMIM companies**

The median total compensation decreased by 8.6% from CHF 169,000 to CHF 154,500. Both the upper and the lower quartile remained relatively stable with a decrease of the upper quartile by 1.3% to CHF 218,217 and an increase of the lower quartile by 0.3% to CHF 106,205. The highest total compensation, however, increased significantly from CHF 3.3 million to CHF 4.1 million (+26.2%).

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**Figure 5: Total compensation of other members of the board of directors in SMIM companies**

Chairman and executive functions excluded (n = 198)
4.1.3 CEOs

Total compensation for CEOs in SMI and SMIM companies generally decreased, which has to be seen in the light of the economic turmoil. In section 4.2, we will further illustrate which elements of total compensation were affected strongest and how share performance impacted compensation of CEOs. In the following graphs, we elaborate on the development of total compensation for CEOs.

SMI companies

In general, the total compensation for CEOs has decreased significantly. The median, for instance, dropped by 30.8% from CHF 7.7 million to CHF 5.4 million. The upper quartile even decreased by 35.1% to CHF 8.2 million and the lower quartile by 21.3% to CHF 3.8 million. The highest paid total compensation decreased by 7.8% to CHF 20.5 million whereas the lowest paid increased by 6.5% to CHF 1.8 million. Overall, this illustrates a downward convergence of total compensation of CEOs in SMI companies for the year 2008 compared to 2007.

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Figure 6: Total compensation of CEOs in SMI companies

1) CEO or highest paid Executive Board member respectively (n = 20)
**SMIM companies**

In the SMIM companies, total compensation of CEOs generally decreased. The highest total compensation dropped from CHF 12.0 million to CHF 7.1 million (−41.3%). The upper quartile decreased by 14.5% to CHF 3.5 million, the median by 8.3% to CHF 2.5 million, the lower quartile by 11.6% to CHF 1.6 million and the lowest total compensation by 8.1% to CHF 930,824.

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**Figure 7: Total compensation of CEOs in SMIM companies**

![Total compensation of CEOs in SMIM companies](image)

CEO or highest paid Executive Board member respectively (n = 28)
4.1.4 Structure of average total compensation of CEOs

Like last year, we have analysed the structure of the average total compensation for CEOs, as we believe this provides important insights in addition to the analysis of the level.

SMI companies

The average total compensation decreased from CHF 9.3 million to CHF 6.9 million (~25.6%). For 2008, the average total compensation was split into 29% as base salary, 16% cash bonus, 40% long-term incentives and 15% other compensation. While the base salary remained basically unchanged (CHF 2.1 million in 2007 vs. CHF 2.0 million in 2008), both the cash bonus and the long-term incentives have decreased significantly. The cash bonus dropped from CHF 2.2 million to CHF 1.1 million (~49.5%) and the long-term incentives decreased from CHF 4.5 million to CHF 2.8 million (~38.6%). The increase of average other payments is mainly due to a one-time payment to an individual which contrasts the general trend.

Figure 8: Structure of average total compensation of CEOs in SMI companies
**SMIM companies**

The average total compensation decreased from CHF 3.8 million to CHF 2.9 million (~23.0%). For 2008, the average total compensation was split into 44% as base salary, 20% cash bonus, 26% long-term incentives and 10% other compensation. While the base salary increased by 9.4% to CHF 1.3 million, the cash bonus decreased by 16.7% to CHF 599,070 and the long-term incentives were reduced by 52.7% to CHF 774,094.

**Figure 9: Structure of average total compensation of CEOs in SMIM companies**

<table>
<thead>
<tr>
<th>Million CHF</th>
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</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>31%</td>
<td>44%</td>
</tr>
<tr>
<td>1</td>
<td>19%</td>
<td>20%</td>
</tr>
<tr>
<td>2</td>
<td>43%</td>
<td>26%</td>
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<tr>
<td>3</td>
<td>7%</td>
<td>10%</td>
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<tr>
<td>4</td>
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</table>
**Key findings**

Overall, total compensation for CEOs dropped by approximately 25% on average. Base salaries remained relatively unchanged but now account for a larger portion of the total compensation as levels have decreased.

Variable compensation (cash bonus and long-term incentives), however, has dropped notably in both the SMI and SMIM companies. Interestingly, the cash bonus decreased by approximately 50% in SMI companies (versus approximately –16% in SMIM companies). At the same time, the long-term incentives decreased by approximately 50% in SMIM companies (versus approximately –38% in SMI companies).

**Table 2: Summary of changes in variable compensation from 2007 to 2008**

<table>
<thead>
<tr>
<th></th>
<th>Cash bonus</th>
<th>Long-term incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMI</td>
<td>–50%</td>
<td>–38%</td>
</tr>
<tr>
<td>SMIM</td>
<td>–16%</td>
<td>–50%</td>
</tr>
</tbody>
</table>
4.1.5 Compensation structure 2008

Total compensation for both the chairman as well as other members of the board of directors (non-executive roles) is predominantly provided in fixed compensation. For the executive board, the variable compensation plays a bigger role than for the board of directors, as outlined in the graphs below.

Figure 10: Overview of compensation structure 2008 in SMI companies

Figure 11: Overview of compensation structure 2008 in SMIM companies
4.2 Pay-for-performance for CEOs

Effective compensation systems tie executive pay to performance. Of course, pay-for-performance is not a guarantee for better performance, but it is one factor in a successful total compensation strategy. Whether Swiss executives get paid for performance is, therefore, an important question – and it is equally difficult to answer.

The reader should bear in mind that the numbers derived from the analysis in this section are not very precisely estimated and subject to large uncertainty and many assumptions. Only additional data over the years will allow analysts to determine whether, in fact, shareholders get performance for pay. In Appendix B, we explain the method used for this analysis as well as technical details.

4.2.1 Total compensation and shareholder return

In a first step, we analysed the relationship between total compensation and total shareholder return in the respective year by applying a partial correlation analysis. Our analysis suggests that over the two years under consideration there is a positive association between total compensation and shareholder return.

There are a number of factors, however, which may bias this result. Therefore, we expanded our analysis by considering other dimensions such as common trends, company size (measured by market capitalisation or assets) and others. In addition, we allowed current pay to be based on past as well as current performance. That is, we allowed TSR in 2006 and 2007 to affect compensation in 2007 and TSR in 2007 and 2008 to affect compensation in 2008.

The result of this expanded analysis shows a robust link between pay and performance. The statistical estimates imply that an average increase of TSR by one percentage point in the current and past year is associated with an additional CHF 80,000 in current total compensation for the CEO.

Although much uncertainty surrounds this estimate, it is helpful to put this number into perspective. The median market capitalisation at the beginning of 2007 of the companies in this sample is about CHF 7,500 million. Therefore, roughly, a one percentage point increase in average TSR per year generates approximately CHF 75 million in value for shareholders in each of the years 2007 and 2008, or CHF 150 million in total. Dividing CHF 80,000 by CHF 150 million and rounding we obtain our overall estimate: for every CHF 1,000 in value generated (destroyed) for shareholders in the past and current year together, a CEO gains (loses)

Figure 12: Total compensation of CEOs of the SMI and SMIM companies and total shareholder return

![Figure 12: Total compensation of CEOs of the SMI and SMIM companies and total shareholder return](image)
about CHF 0.50 in this year’s total compensation. This number is relatively low, compared to international evidence, although that evidence varies widely as well.

We also analysed base salary and variable compensation separately. For base salary, unsurprisingly, we find that there is only a modest link: for every CHF 1,000 created in additional shareholder wealth in the previous year, base salary this year has risen by about CHF 0.01. Naturally, variable compensation is impacted more strongly than base salary. There, the strongest effect of pay-for-performance does not come from cash payments, but from additional equity grants.

4.2.2 Wealth changes due to share ownership

In addition to measuring the impact of share performance on total compensation, it is also important to understand share ownership of executives and changes to wealth due to share price changes. These can be substantial. Table 3 lists the top 25% and bottom 25% wealth changes among Swiss CEOs (as well as chairmen and members of board of directors) in the period between end of 2007 and end of 2008.

The average wealth loss of CEOs considered from end of 2007 to end of 2008 that is implied by their average shareholdings was CHF 9.5 million. However, the distribution is heavily skewed; the median wealth loss is CHF 1 million. The median share ownership is less than 0.03% of the respective company. This shows a generally low share ownership quota of CEOs in their company. It means that a CHF 1,000 change in shareholder wealth in a given year corresponds to CHF 0.30 CEO wealth change. This average share ownership of the median CEO in the years 2007 and 2008 is arguably representative for other years, so that this number can be compared and added to the pay changes calculated in the direct pay-for-performance analysis earlier. These numbers do not reflect implied ownership through options or other instruments similar to equity. They are merely based on what companies report to be the direct alignment of their CEOs with shareholders.

<table>
<thead>
<tr>
<th></th>
<th>Highest gain</th>
<th>Top 25% (upper quartile)</th>
<th>Bottom 25% (lower quartile)</th>
<th>Greatest loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEOs</td>
<td>+230,000</td>
<td>−240,000</td>
<td>−2,000,000</td>
<td>−220,000,000</td>
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<tr>
<td>Chairman</td>
<td>+6,340,000</td>
<td>−300,000</td>
<td>−35,600,000</td>
<td>−2,745,000,000</td>
</tr>
<tr>
<td>Other members of board of directors</td>
<td>+42,830,000</td>
<td>−60,000</td>
<td>−670,000</td>
<td>−3,015,000,000</td>
</tr>
</tbody>
</table>

7) All amounts in CHF and rounded. Wealth changes are calculated as the difference between the wealth due to the average of the reported stockholdings on 31 December 2007 and those on 31 December 2008, valued on 31 December 2008, minus the value of these average shareholdings on 31 December 2007. All shares (not only vested shares) are considered. Companies that do not report shareholdings for the respective category of individuals are not considered in this table.
4.2.3 Combined analysis

We have considered the pay-performance sensitivity of the CEOs of the 48 largest Swiss listed companies. We concentrated on two sources of this sensitivity: changes in total compensation and wealth changes from share ownership. Overall, the results reveal that a CHF 1,000 change in shareholder value over the current and past year combined was associated with approximately CHF 0.80 change in current year median CEO wealth.

For illustration, consider three hypothetical CEOs. They all start with the median shareholder value in beginning of 2007, namely, CHF 7,500 million. The “Median performer” generates median TSRs in years 2007 and 2008. The “Top 25% performer” generates TSRs in the 75th percentile in years 2007 and 2008, and the “Bottom 25% performer” generates TSRs in the 25th percentile in years 2007 and 2008. Table 5 shows the implications for shareholders and CEO wealth in these three cases.

Table 4: Two channels of performance-related pay

<table>
<thead>
<tr>
<th></th>
<th>A CHF 1,000 change in shareholder wealth is associated with ...</th>
<th>change in median CEO wealth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct share ownership</td>
<td>0.30 CHF</td>
<td></td>
</tr>
<tr>
<td>Total compensation</td>
<td>0.50 CHF</td>
<td></td>
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<tr>
<td>Total</td>
<td>0.80 CHF</td>
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</table>

Table 5: Three illustrative examples⁸)

<table>
<thead>
<tr>
<th></th>
<th>TSR 2007</th>
<th>TSR 2008</th>
<th>Overall TSR</th>
<th>Shareholders wealth change in CHF</th>
<th>Approximate CEO wealth change in CHF relative to zero TSR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 25% performer</td>
<td>+61%</td>
<td>-9%</td>
<td>+47%</td>
<td>+3,525,000,000</td>
<td>+2,820,000</td>
</tr>
<tr>
<td>Median performer</td>
<td>+43%</td>
<td>-23%</td>
<td>+10%</td>
<td>+750,000,000</td>
<td>+600,000</td>
</tr>
<tr>
<td>Bottom 25% performer</td>
<td>+22%</td>
<td>-41%</td>
<td>-28%</td>
<td>-2,100,000,000</td>
<td>-1,680,000</td>
</tr>
</tbody>
</table>

⁸) Note: Overall TSR is calculated as (1+TSR2007)(1+TSR2008)−1. All numbers are rounded. The baseline is shareholder wealth of CHF 7,500 million at the beginning of 2007. The example should be interpreted with care because the estimate of the performance sensitivity of total CEO compensation applies to small (marginal) TSR changes and is a less precise approximation for large changes.
5 Boards of Directors in Theory and Practice

Only a strong board can implement an effective total reward system. But what actually makes for a good board of directors? This is a hotly contested topic in practice and research. Regulators worldwide have demanded specific features and processes that boards need to obey (the Sarbanes-Oxley act in the USA being a particularly pronounced example). Much emphasis has been put on the notion of “board independence,” according to which boards should, in particular, be independent of their CEOs. The basic idea is clear enough: an independent, strong board will be a balancing force to a CEO who might, if unchecked, engage in actions that are not necessarily in the shareholders’ and stakeholders’ interest. To operationalise this idea, regulators and shareholder advisory services have developed checklists, according to which individual directors are classified as “independent,” “insiders,” “grey directors,” and so on.

What is the actual relevance of these categorisations? How should boards themselves think about them, or should shareholders consider them in their decisions where to invest? One way to answer this question is to consider a broad sample of companies and to try to establish a statistical link between features of the board and performance. On the whole, the many studies on the performance implications of board independence studies (from both the USA, where most early studies were done, as well as from international environments, where data has become available only quite recently), reach a sobering conclusion. It is far from clear that board independence, quantified in the above-mentioned ways, is related to firm performance; and compared to that it is even less clear that greater board independence causes improved firm performance.

Third, the overall value effect of a high proportion of independent directors is ambiguous. In fact, until a few years ago, the consensus in research was that there in fact existed no robust link between independence and firm performance (measured, for example, by shareholder returns, return on assets, market-to-book ratios, and so on). The past few years have brought about new and appropriate statistical methods to address this important question. Several of these very recent papers do find that board independence leads to better performance. But the overall verdict is still out. The ambiguous results suggest that there is a difference between boards fulfilling the formal criteria for independence on the one hand and those actually behaving independently on the other hand. Board competence is a central catalyst for actual independence. Importantly also, there seem to be significant differences across countries, legal institutions and cultures that are not yet well understood. We caution against copying blueprints of successful boards from other countries, especially from the USA and the UK.

What do we make of these results for practical purposes? Clearly, there is no blueprint for success. Not only does this imply that Swiss (and other) regulators would do well not to overregulate board composition, it also means that firms need to establish a clever solution for their own individual situation.

From our experience, a number of “soft” factors are relevant in establishing a strong board.

- First, the chairman obviously shapes the workings of a board to a particularly far-reaching extent. It is, therefore, imperative to be careful when choosing a chairman.
- Second, getting a grip on group dynamics is as important for a board as it is for any other group.
- Third, an effective boards needs to ask itself: Are we looking at the important numbers (and not just a broad assembly of data)? Are we asking the right questions?
- Fourth, having in place an appropriate information architecture – ensuring an efficient flow of information to and from the board – is critical.
6 Concluding Remarks

The heated political debate has spurred regulators into action, both in Switzerland and globally. Most notably at the time of our research, the Swiss Financial Market Supervisory Authority (FINMA) has published draft guidelines on minimum standards for remuneration systems of financial institutions. They are expected to come into effect as of 1 January 2010. At the same time, the debate on compensation has also influenced the current revision of Swiss corporate law. It will affect all industries once it has been passed. This anticipated change is geared towards enhancing shareholder rights (e.g. say on pay).

In the view of these complex circumstances, there seems to be a tendency to overregulate compensation matters in Switzerland. While a regulatory framework is needed, it should not be too restrictive. Otherwise, companies will not be able to develop and operate compensation systems which are competitive in the market and support sustainable long-term performance.

Especially in the current economic climate, it is time to rethink total compensation systems and see them in the context of a new overall picture. The right compensation system for a particular company depends directly on its business strategy and the environment in which it operates. A balanced compensation system is one that offers long-term incentives, is geared to strategic objectives, and includes risk taking in the evaluation of performance and results.

The ultimate responsibility of developing such compensation systems lies with the board of directors. It is, therefore, essential that the members of the board of directors have the required competencies and are not only formally independent, but also act in such a manner. This is a cornerstone of good corporate governance. An effective board ensures the right principles are set and implemented and adherence is monitored. We believe that the following six principles are central to success:

1. Only a strong board can implement an effective total compensation system.
2. The incentive system must be designed as a “best fit” with company strategy – and it needs to be communicated as such.
3. Compensation should be linked to a few key performance indicators (KPIs), but not exclusively to easily controllable factors.
4. Limits to pay are counterproductive.
5. An effective compensation system establishes entrepreneurial incentives.
6. An effective compensation system focuses on value created for the long term.
Appendix
A Companies surveyed (in alphabetical order)

SMI companies
- ABB
- Actelion
- Adecco
- Bâloise
- Credit Suisse
- Holcim
- Julius Bär
- Nestlé
- Nobel Biocare
- Novartis
- Richemont
- Roche
- Swatch
- Swiss Life
- Swiss Re
- Swisscom
- Syngenta
- Synthes
- UBS
- Zurich Financial Services

SMIM companies
- Barry Callebaut
- Basilea
- Ciba
- Clariant
- EFG International
- Galenica
- Geberit
- Georg Fischer
- Givaudan
- Helvetia
- Kühne & Nagel
- Lindt & Sprüngli
- Logitech
- Lonza
- OC Oerlikon
- Panalpina
- Pargesa
- Petroplus
- PSP Swiss Property
- Rieter
- Schindler
- Sika
- Société Générale de Surveillance
- Sonova
- Straumann
- Sulzer
- Temenon
- Valiant
B Methods and additional findings for the analysis of pay-for-performance

When investigating the relationship between pay and performance, not only does the analyst have to decide on how to measure both “pay” and “performance,” but he is also faced with a vexing choice between numerous methodological approaches.

A first question is how to measure pay. Although we conducted many different analyses, in our main approach, we focused on measuring “pay” by the total compensation disclosed in one particular year, in whatever form. We also considered the wealth change implied by the stockholdings of a manager.

Second, the main criterion for “performance” we considered was total shareholder return in the year under consideration. However, return on equity, return on assets and growth in EBIT (among other measures one could calculate), are also potentially useful quantities. In the long run, they all combine towards the same goal; in the short run, like in the two years we consider, these measures may diverge. In analysis available on request, we found that return on equity and growth of EBIT play a role for cash bonuses, but are not related to additional equity grants. Calculating economic profit or economic value added would be theoretically desirable, but it is difficult and fraught with additional uncertainties.

Third, how do we establish a link between pay and performance? Although this extends into the realm of statistical analysis and, as such, is something not typically considered in popular discussions, attacking this issue correctly is important when evaluating managerial compensation in Switzerland and other countries. Many studies consider the correlation between pay and performance; equivalently others plot pay and performance measures in a diagram and try to see whether there is a line with a positive or negative slope through the points. We also started with this, as it provided some initial insight.

This method has the advantage that it is simple. Unfortunately, this method is also flawed because it ignores a critical problem: the results can be heavily biased as not all influencing factors can be controlled for by the analyst. To see why, consider a factor (say, CEO skill) that affects both firm performance and CEO compensation. Skilled CEOs generate good performance, and they receive high compensation, because boards have to pay them well, due to their outside opportunities. Thus, we would see a positive correlation between pay and performance. This is an interesting observation, but it can be shown that, in this case, we are overestimating the actual link between pay and performance. Conversely, a study that finds a negative or no correlation between pay and performance could incorrectly conclude that there is no pay-for-performance. However, this conclusion could be due to the fact that the analyst did not control for a factor that drives up pay but drives down performance. For example, large firms pay more than small firms, but tend to deliver, in expectation, smaller returns. Or, if the analyst does not take into account CEO power vis-à-vis the board (which is very difficult to do), he would overlook that powerful CEOs are able to pay themselves a lot, but at the same time do not deliver as much shareholder value. Any of these stories (and many others) would obscure any inference about the actual link between pay and performance.

Several methods are available for addressing this problem. First, one can control for some factors known to play a role. For example, in all our analyses, we controlled for size (measured by market capitalisation, or assets). We also included a time trend that is common to all companies (compensation decreased over the two years under consideration). However, this does not go far enough as there may remain unobserved factors. A second approach at least partially dealt with this latter problem: we controlled for so-called firm fixed effects. Essentially, in our analysis, we separated out all unobserved differences between companies by considering pay and performance changes across years instead of levels. Thus, if CEO skill or CEO power does not change over time, this would ameliorate, if not eliminate, the above and similar concerns. Our analysis also automatically took care of differences between industries.
Using these methods turned out to be important. A raw regression of total pay on total shareholder return (corresponding, essentially, to the correlation between these two quantities), leads to the result that TSR and pay are positively linked and, in fact, statistically significantly so (this is what Figure 12 indeed suggests). However, using controls for company size, a common time trend, and fixed effects, we found the following: for the overall sample of CEOs, no significant relationship exists between total pay and performance in the current year. That is, the graphical relationship is spurious and misleading, at least if one is interested in determining a causal link between performance and pay. It is true that there is a positive correlation between the two quantities, but our statistical analysis reveals that this correlation arises because there are some other factors that drive both of them. Only when we considered the intertemporal dimension of performance (last year’s and this year’s TSR\(^9\)) did we find a significant relationship between performance and pay, as reported in the main text. This still does not completely provide rigorous proof of a causal link between performance and pay, but it is the best that can be done with the existing data.\(^{10}\)

Fourth, what data should one use? Obviously, time series data are crucial to using the method we have described. In fact, this is the first time that such an analysis could be conducted for Switzerland. Despite having taken as much care as possible in the analysis, we must draw attention to the fact that, due to the lack of availability of an extended time series of data, the analysis here is, at most, suggestive. Not only are there only two years of data, but these are very special years (hopefully). Only in three or five years will it be possible to conduct a more complete analysis.

Fifth, while we have presented the results for the overall sample in the main text, interesting additional insights can be gleaned from analysing subsamples. For example, we uncovered some limited evidence that pay-for-current-performance does seem to exist among the group of CEOs who do not receive the highest amounts. For high earners, performance is linked mostly to past year’s total shareholder returns. As a second example, excluding those two CEOs with significant sign-up bonuses changes the results in the direction of increasing pay-performance sensitivity for lesser-paying companies, decreasing it for higher-paying companies and overall decreasing pay-performance sensitivity. Instead of CHF 0.50 per CHF 1,000 in shareholder value, a CEO then receives about CHF 0.35. On some level, it is clear that a multi-million sign-on bonus is an outlier. On the other hand, the question for shareholders is not so much whether they paid a given CEO to perform, but whether the amount they paid for compensation is associated with performance. For different purposes, different analyses are suitable.

Finally, other potential sources of incentives exist that could be analysed only with additional data. First, staying at the same firm, firm performance may be rewarded by a permanent shift in the base salary and bonuses. It is conceivable that this factor adds several multiples to the direct effect on increased pay. Second, good performance is in the long run associated with improved job opportunities and accelerated compensation growth. Third, we have not calculated here the implied pay-performance sensitivity that arises from the fact that CEOs can and do get fired for poor performance. When their contracts are terminated, they frequently lose the unvested portion of their equity-based pay and most (though not all) will work at comparatively much smaller companies that do not pay them as much in the future. Research from the US suggests that this effect is not very strong, except in those companies with rigorous boards.

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\(^9\) This means that in some circumstances, a CEO may get rewarded or punished for the performance of a predecessor.

\(^{10}\) Even fixed effects estimation is not the panacea. For example, if there are dynamic effects in that past values of compensation affect performance, this may also bias the estimates. Other complex methods exist to address this problem and should be used once increasingly reliable data become available.
For further information about this survey or our services in the field of compensation planning for executives and applicable governance, disclosure and accounting requirements, please contact:

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Other recent PwC publications on the subject of Executive Compensation & Corporate Governance:

- Reward: A new paradigm? Financial services sector post credit crunch, 2008 (English)
- Global Equity Incentives Survey 2009 (English)

If you would like further copies of this survey or of the above publications, please contact:

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8050 Zurich  
Switzerland  
Phone: +41 58 792 45 31  
Email: heidi.faessler@ch.pwc.com
### Chairman SMI SMIM

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<td>7,418,000</td>
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### Board of Directors SMI SMIM

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## Comparison of total compensation

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2009 survey examining compensation structure in SMI and SMIM companies as well as an analysis of pay for performance for CEOs

www.pwc.ch/reward