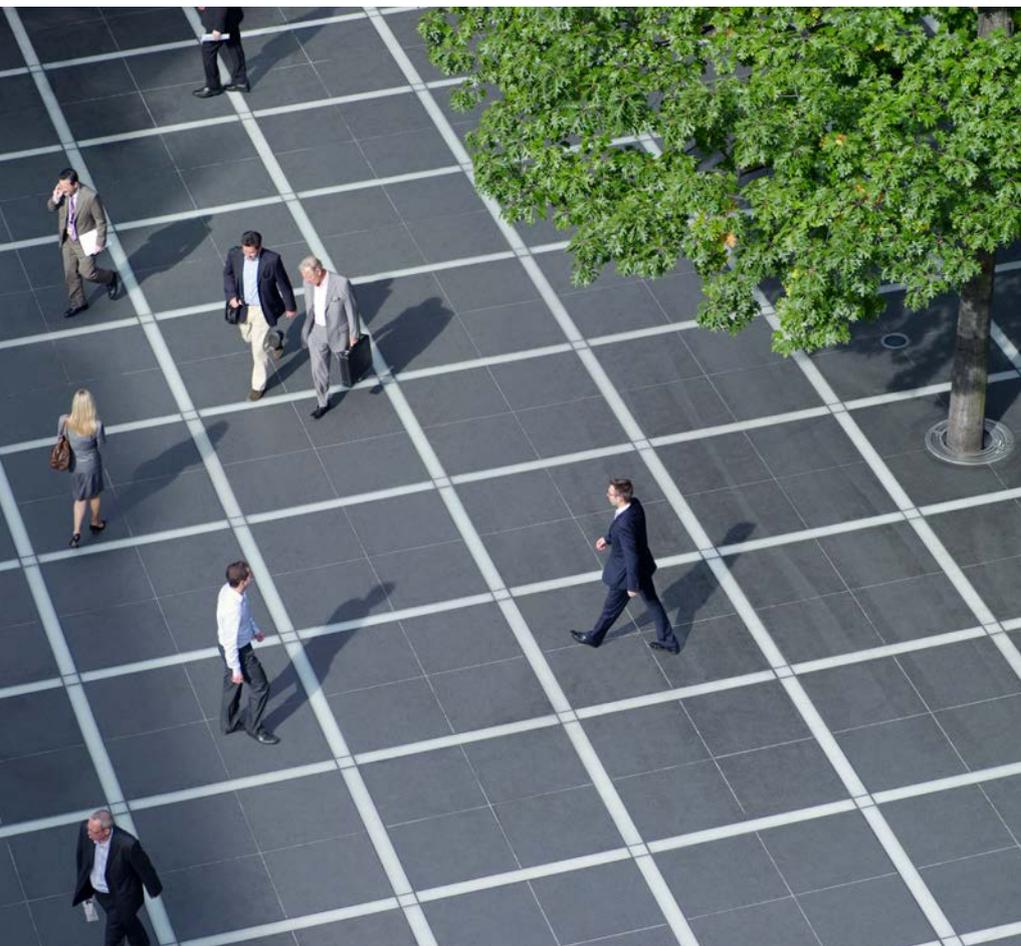


Executive Compensation & Corporate Governance



A study examining compensation in SMI, SMIM and small-cap companies as well as trends in corporate governance

Introduction ExCo Insights 2017

How have pay levels of executives and board members developed over time? Are there differences across industries? What are the main trends in pay structure? Is there a connection between pay and performance, or is pay decoupled from actual delivery of results for shareholders and other stakeholders? What performance criteria should be relevant for determining pay? How should companies communicate with shareholders, employees, the media, and society at large?

To help answer these questions, and to engage PwC clients in a dialogue, every year for over a decade PwC has presented one of the most detailed Swiss studies available on the level and structure of board and executive compensation. We are delighted to present the eleventh edition of our study “Executive Compensation & Corporate Governance Insights”. This study comprises the years from 2007 to 2016 and is based on the largest 100 listed Swiss companies.

This year, we have presented the outcomes of the study in a few shorter Insights releases throughout the fall. The notes are, however, closely related, and we hope that you will enjoy the breadth of perspective offered when considering them as a whole in this compendium.

1. Insights 2017, part 1, released in October 2017, studies the level of compensation of CEOs, other executives, and chairmen and other board members in Swiss listed companies, and thus provides valuable insights for board members and executives seeking the right quantum of compensation.
2. Insights 2017, part 2, released in November 2017, investigates the question that has led to emotional discussions: do Swiss executives get paid for performance? Understanding the facts helps board members and executives benchmark the situation in their own companies
3. Insights 2017, part 3, released in December 2017, covers new methods of pay design and an analysis of the demands of shareholders in the upcoming annual general meeting season. This analysis helps companies to prepare for communication with stakeholders.

We look forward to engaging in dialogue with you.



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Introduction ExCo Insights 2017, part 1

PwC's ExCo Insights 2017, part 1, summarizes the key highlights for the largest 100 Swiss listed companies regarding the level of compensation of CEOs and other executives, as well as chairmen and other board members. Then, it studies the much-discussed differences between financial services (FS) and non-financial services (non-FS) companies – and unearths some arguably surprising patterns.

Our data facilitate a wealth of other analyses. Here we highlight only a few key points, but we are happy to engage with you in a dialogue about aspects of compensation which are of particular interest to you.

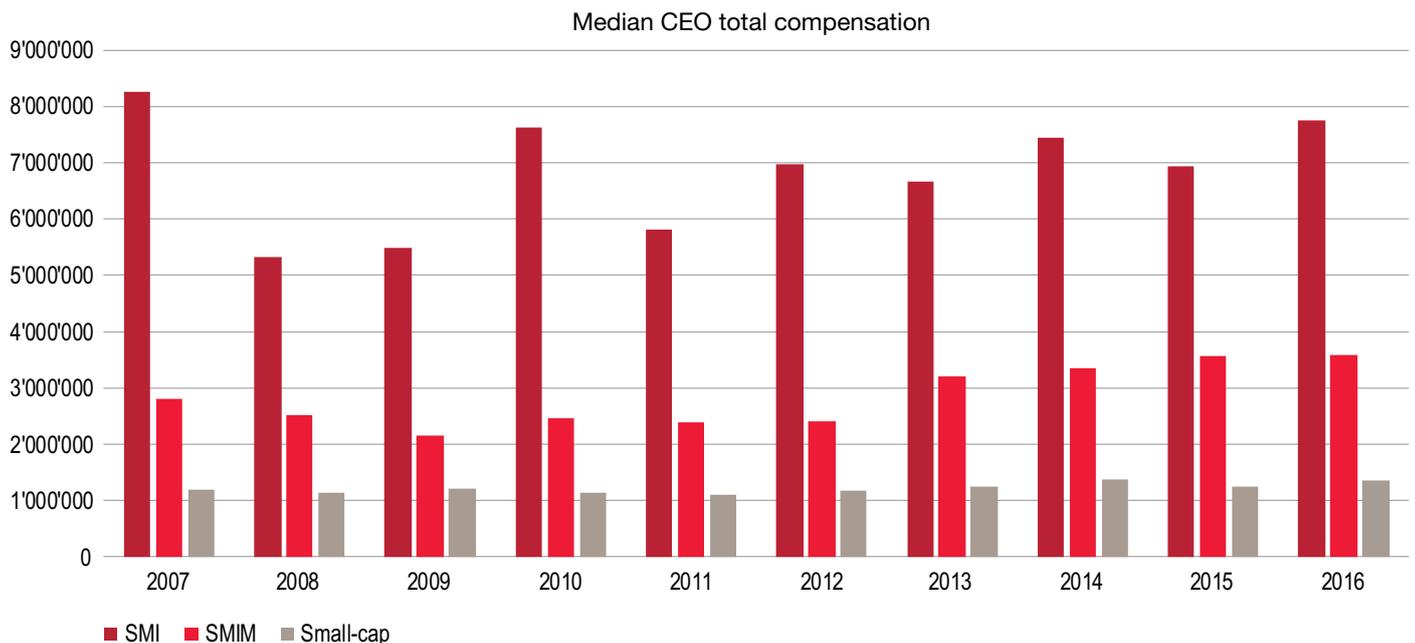
The key findings are:

1. Total CEO compensation in the largest 100 companies has increased markedly over the past few years. From 2009 to 2016, median total CEO compensation has increased by 41.2%, 67.0% and 12.1% for SMI, SMIM and small-cap companies, respectively.
2. CEO compensation in SMIM companies is catching up with compensation in SMI companies – but a divergence is seen in compensation of CEOs at SMIM and small-cap companies.
3. The overall rise in executive compensation since 2009 has mostly been driven by non-financial-services (non-FS) companies rather than FS companies. For example, median CEO compensation in non-FS SMI companies has increased by roughly 50% since 2009, while it has actually fallen by around 27% in FS companies.

Compensation levels in SMI, SMIM, and small-cap companies

- Taking 2009 as the reference year, median total CEO compensation has increased through 2016 by 41.2%, 67.0% and 12.1% for SMI, SMIM and small-cap companies, respectively. The median total CEO compensation of SMI companies is now CHF 7.7 million, whereas in 2009 it was CHF 5.5 million. In SMIM companies it was CHF 3.6 million in 2016 versus CHF 2.2 million in 2009. In small-cap companies it was CHF 1.4 million vs. CHF 1.2 million in 2009. Figure 1 illustrates these striking developments. This figure also shows that 2007, the last year before the financial crisis, was “special”: SMI and SMIM firms in particular appear to have experienced unusually high executive compensation in that year.
- What Figure 1 does not show is that extremely high CEO compensation levels (above CHF 20 million), prevalent in a few SMI companies in the years 2007-2009, have vanished in recent years. Therefore, the average CEO compensation in SMI companies, at CHF 7.66 million, is slightly lower than in 2009, when it was CHF 7.73 million. In SMIM and small-cap companies, average compensation is now CHF 3.9 million and CHF 1.7 million, respectively, up 36.0% and 16.8% from 2009. (These numbers are not shown in the figure, but the detailed statistics are available on request).

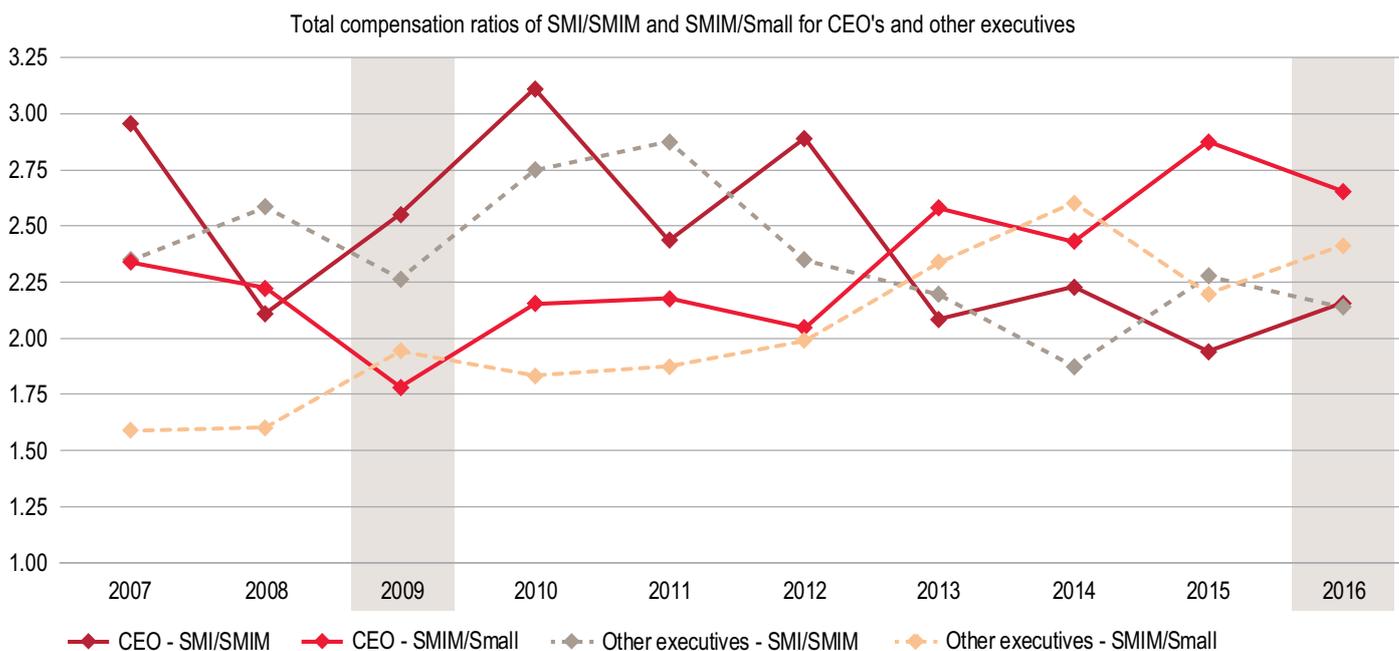
Figure 1: From 2009 to 2016, median total CEO compensation increased by 41.2%, 67.0% and 12.1% for SMI, SMIM and small-cap companies, respectively



- When assessing compensation levels, it is also important to keep structural differences in mind. These differences are discussed in PwC Exco Insights 2017, part 2.
- Figure 1 shows that it is still the case that larger companies pay substantially higher total compensation. What we are also observing, however, is that CEO compensation at SMIM companies is catching up significantly with CEO compensation at SMI companies – and a divergence of compensation at SMIM and small-cap companies is being

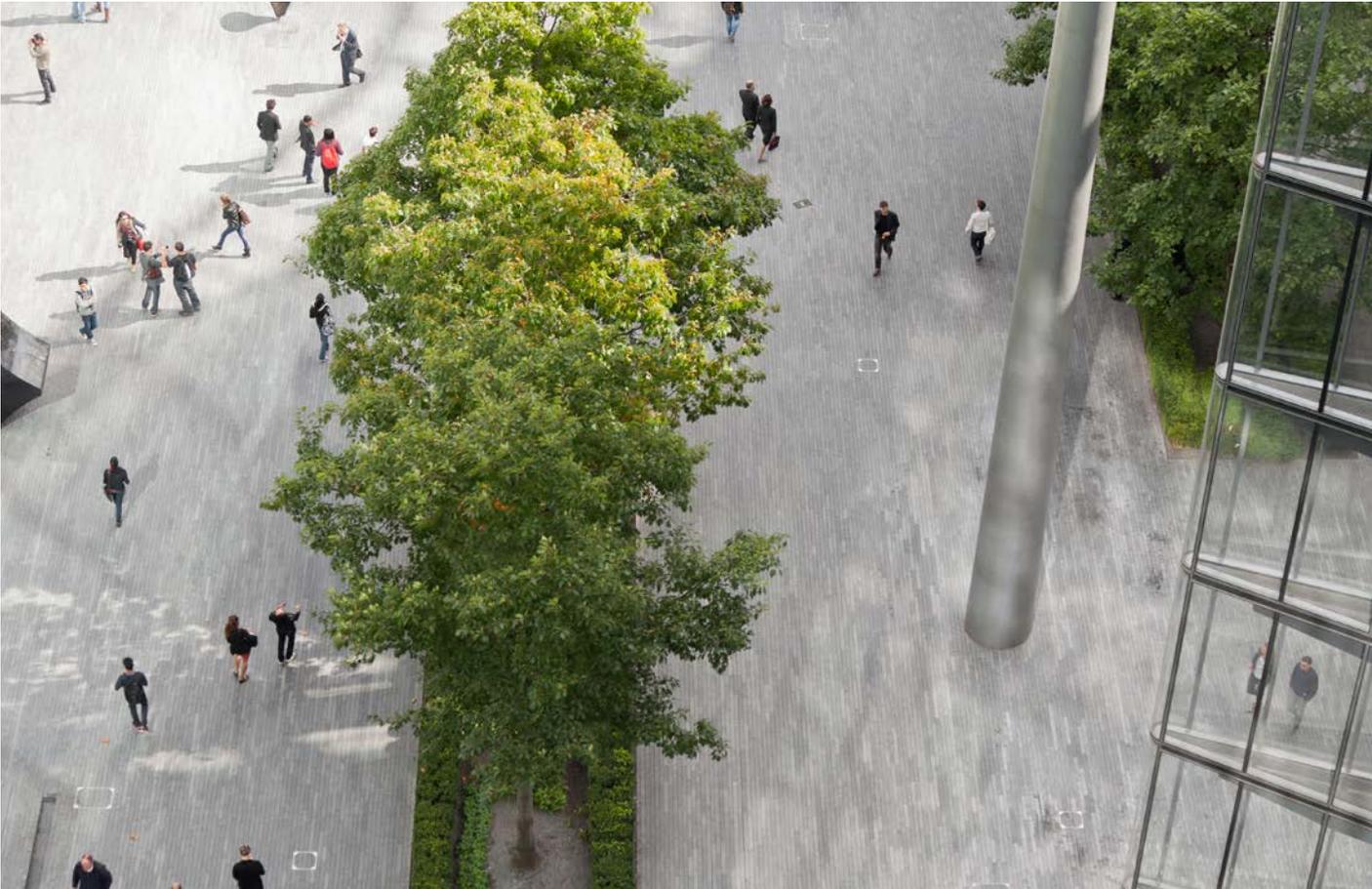
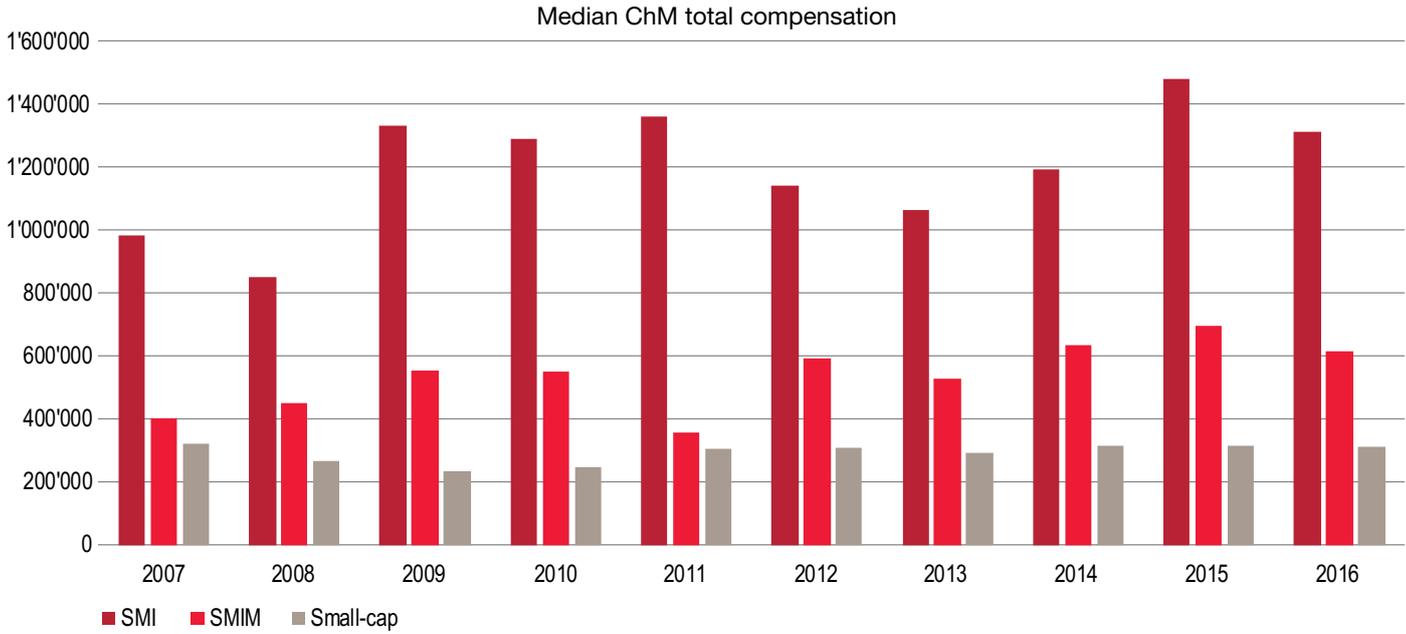
seen. Figure 2 illustrates this point. The two solid lines show that the median SMI CEO earned, in 2009, 2.55 times what the median SMIM CEO earned, and the median SMIM CEO earned around 1.78 as much as the median small-cap CEO. By 2016, the first number had fallen to a multiple of 2.16, while the second had increased to a multiple of 2.65. A qualitatively similar development can be observed for other executives, as shown by the dashed lines.

Figure 2: SMI and SMIM CEO compensation is converging – but a divergence is seen in compensation of CEOs at SMIM and small-cap companies



- While this note focuses on executive compensation, we have also analysed data for chairmen and board members. Briefly, from 2009 to 2016, median non-executive chairman compensation remained stable for SMI companies, at around CHF 1.3 million, though this is substantially above the 2007 level (CHF 1.0 million). In SMIM companies, chairman compensation has increased by 11.0% from around CHF 554,000 in 2009 to around CHF 615,000 in 2016. A major increase took place from 2007 to 2009, when compensation was CHF 403,000 at the median. In small-cap firms (the next largest 50 companies), median chairman compensation remained at around CHF 311,000 this year, 32.4% above the 2009 level, and similar to 2007. Figure 3 illustrates these findings.
- The remuneration of other members of boards of directors who have no executive functions has remained more or less the same since 2007 (and 2009) among SMI companies, and increased for SMIM and small-cap firms. In 2016, the median board member of an SMI company received about CHF 300,000 (+1.0% since 2007, -2.6% since 2009), the median board member of an SMIM company about CHF 212,000 (+25.1% since 2007, +29.3% since 2009), and the median board member of a small-cap firm CHF 126,000 (+16.6% since 2007, +41.5% since 2009).

Figure 3: In SMIM and small-cap firms, chairman compensation has been increasing since 2009



Analysis by company sector: financial services (FS) vs. non-FS companies

The financial services (FS) sector, such as banks and insurance companies, is of great importance to Switzerland. At the same time, when it comes to compensation, this sector has received the greatest criticism. Together with some of the pharma companies, several of the biggest financial institutions have been in the spotlight of the media and have received critical public attention. Some would argue that the resounding acceptance of the Abzocker-Initiative in 2013 was largely driven by a perception of disproportionate executive compensation in the financial sector, especially in light of the financial crisis.

What is actually the evidence on compensation in the FS sector versus the other sectors? Of course, such an analysis is challenging because of the relatively small sample size. For example, in 2016, there were 6 SMI, 6 SMIM, and 18 small-cap FS companies. Lumping all 30 of them together and comparing them with the around 70 non-FS companies is not possible due to differences in size. Still, the question of differences in pay across sectors is of great importance, and we therefore seek to stimulate a discussion of this question with the following data, exerting the necessary caution against too definitive generalisations. We also emphasize that with this data we can make no statements about compensation outside the executive compensation ranks, as no such compensation is typically disclosed in a manner that allows meaningful comparisons. Computations of average wages per employee are difficult due to lack of comparable employee numbers data.

Table 1 illustrates a familiar picture – but also facts that may be surprising. First, in 2009 at the largest companies, the SMI firms, median compensation of CEOs and other executives in the financial services firms was substantially higher – indeed twice as high or even two and a half times higher – than median compensation of such executives in non-FS firms. We suspect that this observation has cemented itself in the public perception. SMI FS firms still pay their CEOs and other executives more than SMI non-FS firms in 2016. However, the table shows that the difference is now much smaller, with a pay differential of roughly 20%.

Second, outside of the SMI companies, total compensation of FS-firm CEOs and other executives in 2016 was lower than in non-FS firms. For example, the median small-cap financial services CEO earned CHF 1.2 million, while the median non-FS CEO in this size class earned CHF 1.4 million. Even in 2009, CEOs earned about the same in the two sectors. Of course, the small-cap FS sample comprises some cantonal banks, but this analysis serves to illustrate the point that the broad generalisation that the financial services sector as such is higher-paying for executives than other sectors is not always accurate.

Table 1: Median executive compensation (in CHF) – some surprising facts

		2009			2016		
		SMI	SMIM	Small-cap	SMI	SMIM	Small-cap
CEOs	FS	12,597,000	2,151,000	1,141,985	9,192,500	2,151,909	1,198,000
	Non-FS	5,150,096	2,109,900	1,249,500	7,746,511	3,731,000	1,435,276
	Ratio	2.45	1.02	0.91	1.19	0.58	0.83
OEx	FS	5,722,143	1,200,500	695,183	4,182,178	1,504,758	687,527
	Non-FS	2,755,792	1,237,402	580,225	3,537,919	1,702,541	688,756
	Ratio	2.08	0.97	1.20	1.18	0.88	1.00

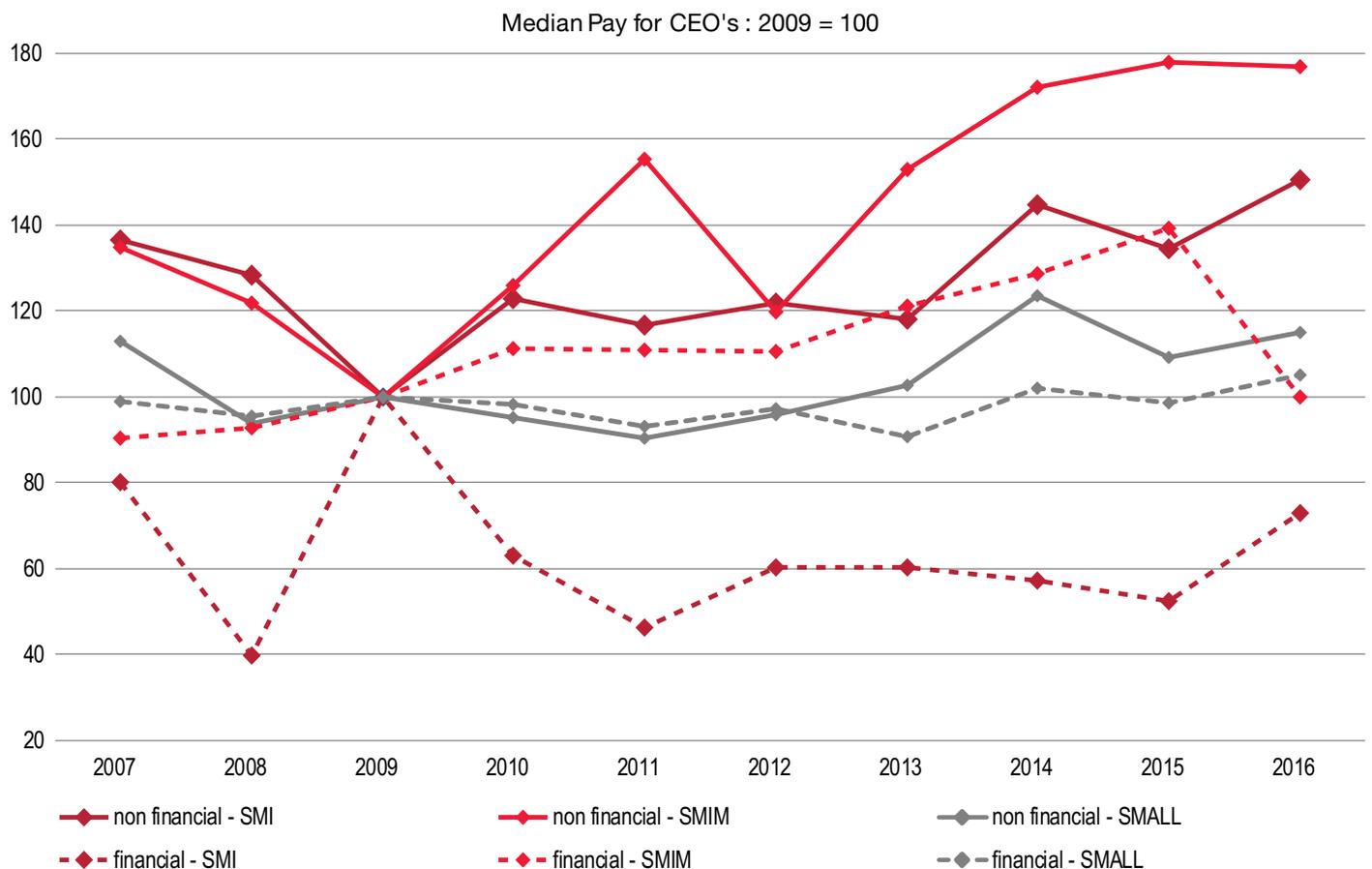
Most importantly, consider the changes over the years, as illustrated in Figure 4. This figure indexes CEO compensation to a level of 100 in 2009 for each of 6 groups: 3 size groups (SMI, SMIM, small-cap) and 2 sectors (FS and non-FS). The non-FS firms are the solid lines. This figure makes it easy to identify growth (above 100) and decline (below 100) in compensation.

Strikingly, all three solid lines end up substantially above 100% in 2016, meaning that non-FS companies have experienced significant CEO compensation growth. By stark contrast, the three dotted lines show that CEO compensation in FS firms either dropped sharply in the years 2010 and 2011

and has stayed stable since then (in the case of SMI firms), or it has increased, but not nearly as fast as non-FS firms, with a big drop in the final sample year (in the case of SMIM firms), or it has remained essentially flat (as in the case of small-cap firms).

In sum, this analysis shows that executive compensation in non-FS companies has increased substantially faster than compensation in FS companies. Indeed, the overall trends in compensation observed at the beginning of this note are driven not by banks and insurance companies but by companies in the other sectors of the Swiss economy.

Figure 4: Non-financial services companies – not banks and insurance companies – have been driving the increase in CEO compensation since 2009



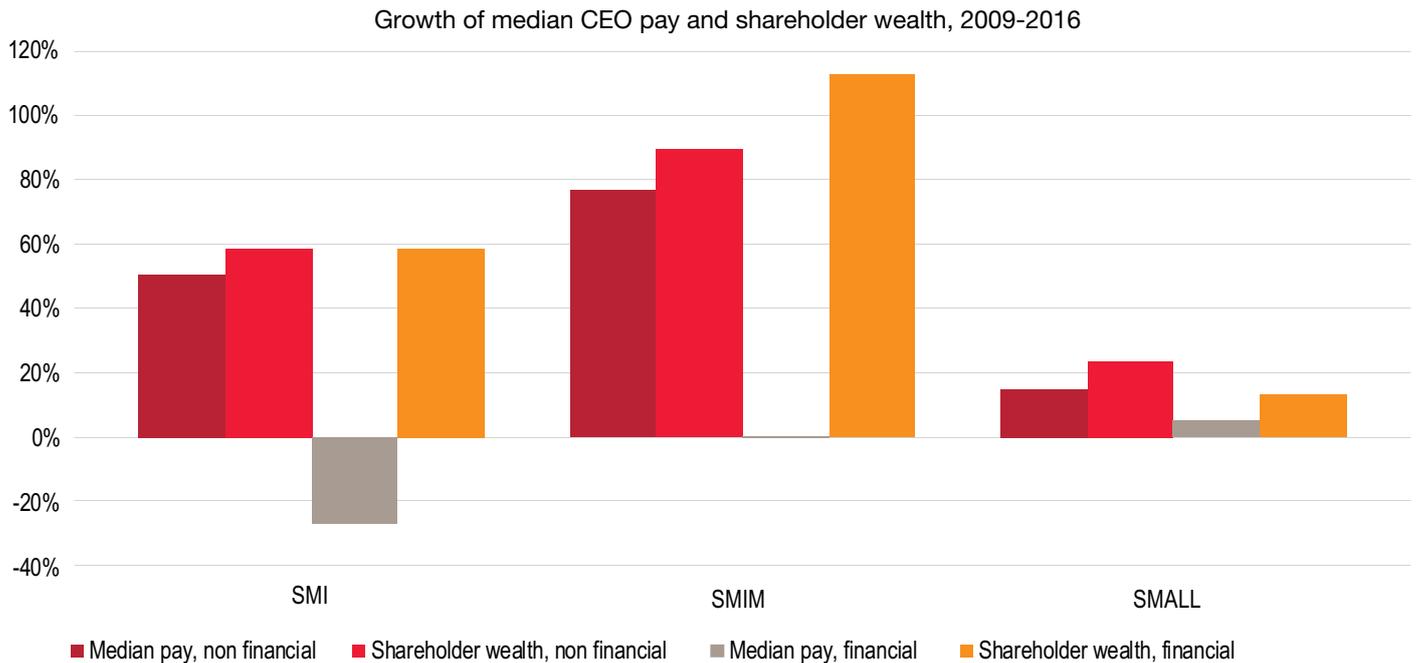
Summary part 1 and outlook part 2

In short, this analysis shows that executive compensation has developed dynamically in Switzerland in the last 11 years. Important pre-conceptions – for example, that executive compensation in the financial services sector is always higher than in the other sectors – does not hold up against actual analysis of the data once the sample is extended outside the few largest companies that many other studies consider.

Of course, when assessing compensation, a key issue is not only the level of compensation, but also the structure of compensation, and how (variable) pay relates to the performance of the company. Insights 2017, part 2, covers this topic in more detail. For now, consider Figure 5 as a “teaser”.

It plots the growth rates in median CEO pay against growth in shareholder wealth, measured as median total shareholder returns (capital gains and dividends) in the respective groups. As seen above, compensation in non-FS firms grew faster than in FS firms. The main insight to be gleaned from the figure is that shareholder wealth grew faster than CEO compensation in each subsample. (In SMI and SMIM companies total shareholder returns in FS companies have actually, at the median, been as high or greater than returns in non-FS companies. Of course, here we need to keep in mind that share prices of FS companies after the financial crisis were arguably significantly lower.)

Figure 5: Shareholder wealth has grown faster than CEO compensation since 2009





This aggregate analysis suggests that overall executive compensation and shareholder wealth have moved together when considered over a long time period (or that, indeed, shareholders tend to have seen greater growth in their wealth when compared to the rate compensation has grown at). However, this does not necessarily say much about the pay-performance relationship at individual company level, and it does not say anything about the link on a year-by-year basis. Is there pay-for-performance when we look more closely? Find out in PwC Insights 2017, part 2.

Insights 2017 - part 2

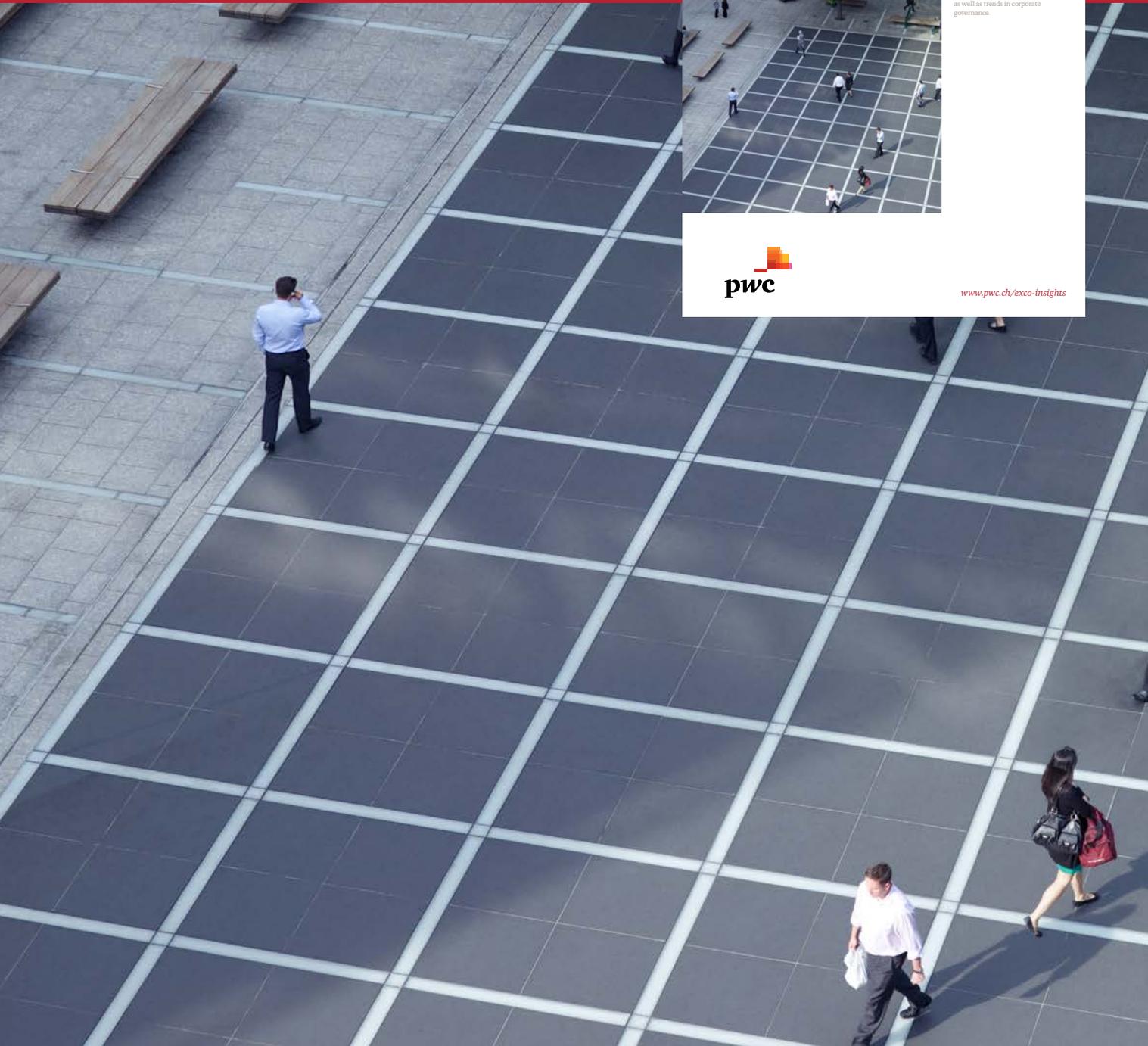
Executive Compensation & Corporate Governance



A study examining compensation in SML, SMIM and small-cap companies as well as trends in corporate governance



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Insights 2017 - part 2

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Introduction ExCo Insights 2017, part 2

The first part of ExCo Insights 2017 summarised the key highlights for the largest 100 Swiss listed companies regarding the level of compensation of CEOs and other executives, as well as chairmen and other board members. Then, it studied the much-discussed differences between financial-services (FS) and non-financial-services (non-FS) companies – and unearthed some arguably surprising patterns. Specifically, the overall rise in executive compensation since 2009 has mostly been driven by non-FS companies rather than FS companies.

PwC's ExCo Insights 2017, part 2 now focuses on pay-for-performance in Switzerland. For an overall assessment of this challenging topic, one has to consider multiple perspectives.

The key findings based on our ten years of data for 100 Swiss companies are:

1. 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 9.5% at the median. In the bottom tercile of industry-adjusted share performance, variable CEO compensation falls by 3.8% compared with the previous year. This points to a working, but quantitatively modest direct pay-for-performance relation.

2. 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 14%; in the bottom tercile, it is 21%. Because after a turnover for poor performance, CEOs tend to work at smaller companies (if at all), a strong board can induce substantial implicit pay-for-performance and, thus, incentives.
3. Equity-based compensation has risen moderately over the last few years (but has somewhat declined in the most recent year of the sample). The median CEO holds 3.9 times his base salary in terms of equity wealth in the company he manages, inducing substantial exposure to the performance of the firm.

We hope that this analysis provides useful background and benchmark information as companies, boards, managers, and policymakers reflect on the adequacy of incentive systems in Swiss companies. Based on the results presented in this part 2, ExCo Insights 2017, part 3 discusses new methods of pay design and offers an analysis of the demands of shareholders in the upcoming annual general meeting season.

Direct pay-for-performance

At the end of ExCo Insights 2017, part 1, we presented preliminary evidence of an aggregate connection between pay and performance in Swiss companies: Shareholder wealth grew faster than CEO compensation in each subsample. That aggregate analysis suggested that overall executive compensation and shareholder wealth have moved together when considered over a long time period (or that, indeed, shareholders tend to have seen greater growth in their wealth when compared to the rate compensation has grown at). However, this does not necessarily say much about the pay-performance relationship at individual company level, and it does not say anything about the link on a year-by-year basis.

Is there pay-for-performance when we look more closely? To answer this question, several choices need to be made for the analysis. Box 1 explains these concepts in more detail. Briefly, the following four choices are made. First, we focus on total shareholder return (TSR). Second, we look at industry-adjusted, that is, relative performance. Third, we classify as variable compensation all those compensation elements that companies disclose as variable for a given year. Fourth, we look at changes in variable compensation from the prior year for the same CEO.

Box 1: Technical explanation of choices made in the direct pay-for-performance analysis

First, concerning the focus on total shareholder return (share price and dividends, TSR) performance, we note that, of course, in many instances, the CEO cannot directly influence the share price per se – or if he or she can, it is mostly in the downward direction, e.g. through lack of (reputation) risk management. However, all the business decisions the CEO takes (and induces others to take) will ultimately feed into one of two outcome variables: cash flows and/or cost of capital. And these two components determine the share price development. Moreover, for the top 100 companies, it is a reasonable assumption that the capital market reflects the available information efficiently, that current changes in corporate policies – even those that will have an impact on cash flows only further down the road – will be reflected in share prices “today.” Second, for the present purpose, where we wish to isolate the relationship between company-specific performance and changes in variable CEO compensation, an industry-adjusted, relative total shareholder return is the appropriate measure. Third, the definition of variable pay is clearest in the case of the prototypical short-term incentive payment (whether conveyed in cash or in equity). A pure long-term incentive programme, under which, completely regardless of performance in a given year, a CEO receives a fixed number of shares or a fixed value of shares, is not included as variable compensation (although, of course, the ultimate value of this share grant will depend on the future performance of the company). However, even if an equity grant does not depend on the individual performance of a CEO, but according to the company’s description in the compensation report, depends on the company’s overall performance in the past year, then such a grant is classified as variable compensation. To the extent that, despite our best efforts, we assign compensation that is, in fact, a pure, long-term incentive programme (that is regardless of past performance) to variable compensation, we would induce a bias against finding a relationship between pay and performance, because for such a company the (then wrongly classified) “variable” compensation would not, in fact, vary with performance. Fourth, we look at changes in variable compensation from the prior year for the same CEO. This has the big advantage that we do not need to specify the “right” model for determining compensation. Instead, we rely on the idea that, in general, business models do not change substantially from one year to another. Another consequence is that this analysis (deliberately) excludes incoming CEOs, who are in the sample for the first year. Thus, the analysis is not distorted by unusual one-off payments that may be disclosed as variable compensation.

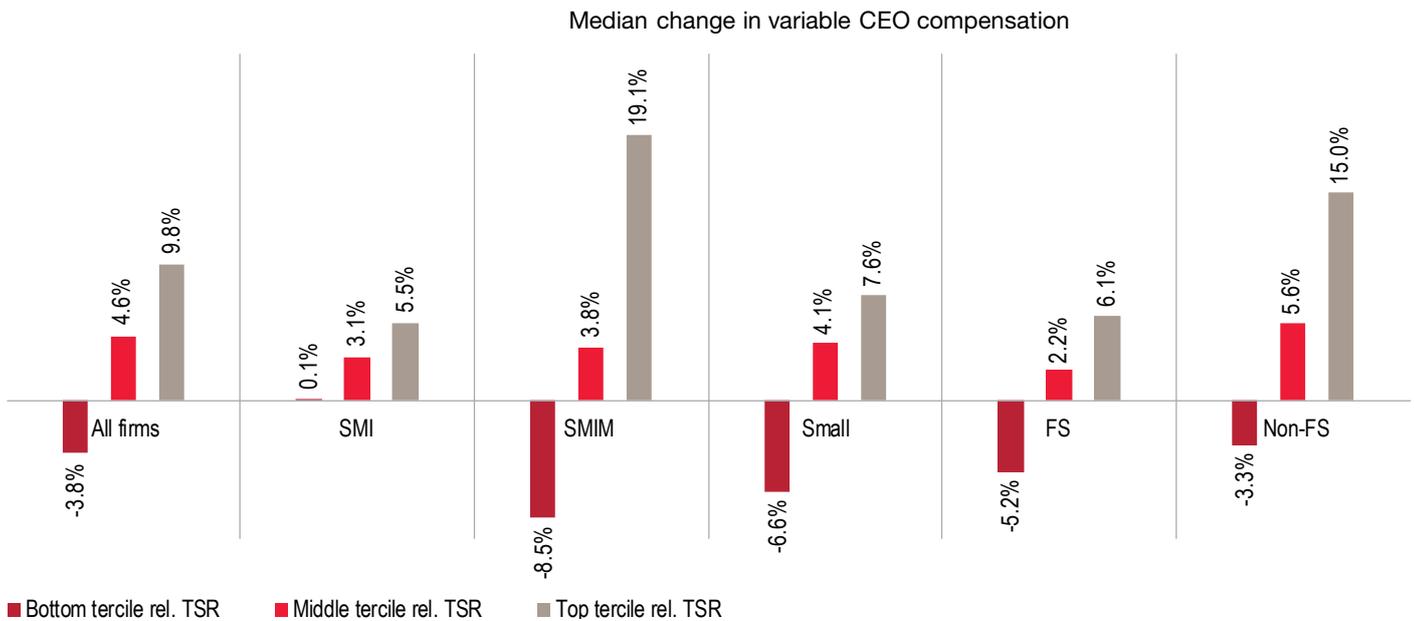
Figure 6: Variable CEO compensation increases when performance is higher

Figure 6 presents the results for median year-on-year per cent changes in variable compensation of CEOs in the three performance tertiles. As can be seen, there is throughout a positive relationship between relative total shareholder return in one year and the change in variable compensation in the following year. As such, changes in shareholders' wealth and the variable compensation of CEOs are aligned. The left-most three columns show that when in a given year a Swiss company achieves a total shareholder return (TSR) in the top tertile 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 9.8% at the median. In the bottom tertile of industry-adjusted share performance, variable CEO compensation falls by 3.8% compared with the previous year.

Figure 6 also shows the results for the three size-buckets (SMI, SMIM, and small-cap) and the two industry groups (financial services and non-financial-services companies). In all cases, there is a monotonic relation between performance and pay. However, the graphs show that variable compensation in SMI firms is, in percentage terms, less sensitive to performance than in either of the two other groups. In the lowest share price performance tertile, variable compensation stays flat for the median SMI CEO, but drops by 8.5% for the median SMIM CEO. In the top tertile, variable compensation increases for an SMI CEO by 5.5% at the median, but increases by 19.1% for the median SMIM CEO. In banks and insurance companies, variable compensation is less performance-driven – as measured by the difference in variable compensation changes in the top vs. the bottom tertile relative TSR – than in non-FS firms.

How big are these effects? Within the lowest tertile of relative TSR, the median relative TSR is –26%. In the top tertile, the median relative TSR is +20%. Thus, being in the top or lowest relative share price performance tertile creates substantial wealth gains or destruction for shareholders in aggregate. The corresponding changes in CEO variable compensation are small in absolute terms. For example, for the median SMIM CEO, when relative TSR is in the top tertile, variable compensation is higher by CHF 180,000 compared with the previous year; when relative TSR is in the lowest tertile, variable compensation decreases by CHF 115,000 compared with the previous year. Thus, the difference in changes in variable compensation in the top tertile minus the change in the lowest tertile is around CHF 300,000 for the median SMIM CEO. Similarly, this difference is around CHF 160,000 for the median SMI CEO and around CHF 40,000 for the median small-cap CEO. One should also keep in mind that we are looking at median variable compensation changes here. Among all groups of companies there are some CEOs, who obtain substantial increases in variable compensation even when performance is poor (and there are some CEOs who see declines in variable compensation even when performance is strong). While in individual circumstances there may be good reasons for such outcomes, they need to be particularly carefully explained to shareholders (and other stakeholders, including the public).

Overall, there is a working direct pay-for-performance relation in Swiss listed companies, but the effects are quantitatively modest. However, as the next two sections show, there are at least two additional effects that need to be taken into account to obtain a balanced assessment of the strength of pay-for-performance incentives.

Indirect pay-for-performance

Boards and policymakers need to bear in mind that there are other sources of incentives and pay-for-performance than the year-by-year bonus payments. Specifically, pay differentials between companies of different sizes (see ExCo Insights 2017, part 1) bring with them a natural element of “career concern incentives.” Managers arguably also take into account that good performance now opens up better career opportunities in the future – in particular the opportunity to manage a larger, higher-paying firm. Conversely, they are aware that poor performance now is likely to result in fewer such opportunities in the future; indeed, poor managers may find themselves slipping down a notch or two in the size of the company they lead, which implies lower pay. When added up over the duration of a career, these forward-looking incentives can be substantial.

Of course, a necessary condition for career concerns is that there is, in fact, a higher likelihood of keeping one’s job if one performs well. In this section, we investigate the turnover-performance sensitivity, that is, the question: How does the probability of turnover vary with performance? Box 2 explains some technical background.

Overall, on average, each year 17% of CEOs change. The turnover ratio varies somewhat: the lowest rate was in 2010 (13%), the highest in 2008 (20%). SMI firms have lower turnover (15%) than SMIM (19%) and small-cap firms (17%).

Box 2: Technical explanation of choices made in the turnover-performance-sensitivity analysis

In this analysis we also include firms, where the CEO is not disclosed in the compensation report (because he/she was not the highest paid in the year). Turnovers here are identified as follows. If the CEO at the end of the prior year is different from the CEO at the end of the year under consideration, this is classified as a turnover. We highlight for the reader two limitations to this analysis which, however, are unlikely to affect the ultimate inferences. First, the method used to identify turnovers may assign a turnover to a year when the new CEO was in fact in office for a large part of the year. More generally, there are necessarily imperfections in the association of the time period, for which performance and turnover are observed. Second, we cannot here distinguish between voluntary and truly forced turnovers. Certainly, some of the turnovers are voluntary. Companies very rarely explicitly state that the board has fired the CEO. The academic literature has resorted to various intricate methods of distinguishing forced and voluntary turnover, but these measures are necessarily imperfect. Some seminal studies use overall turnover as a proxy. For lack of better data, we therefore also use the overall turnover rate in this analysis. To the extent that CEOs are less likely to be fired when performance is good and that the imperfection in the alignment of the timing between observed performance and the firing decision is random across companies, our analysis of the turnover-performance sensitivity will be subject to noise. Such noise would make it less likely to find a relationship between turnover and performance. In this sense, to the extent that we do find a relationship, the results are more compelling.

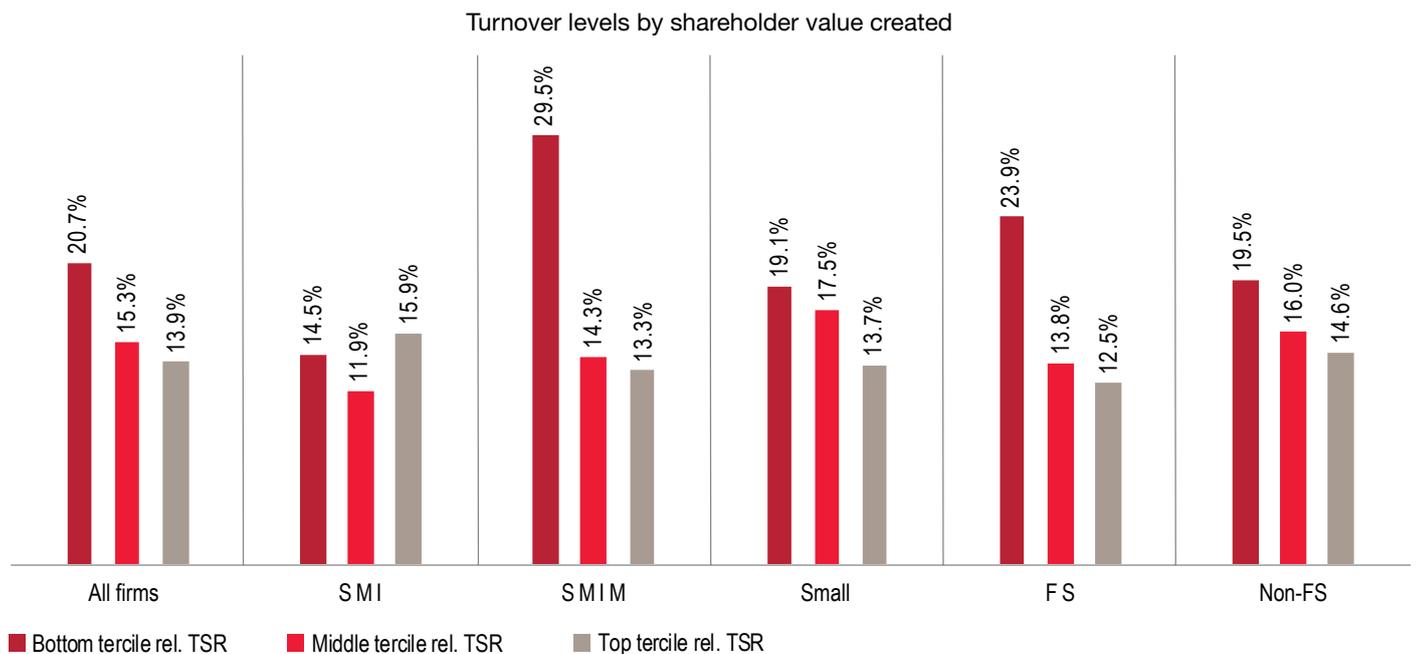
Figure 7: CEO turnover is substantially higher when relative share price performance is lower

Figure 7 shows how turnover and total shareholder performance are related. Again, we use the industry-adjusted share price performance as an indicator of the overall performance.

The first three columns show that the probability of a CEO turnover increases when performance is weaker. Specifically, turnover is by far the highest in the lowest relative TSR tercile. At 20.7%, it is substantially higher than the turnover probability in the second and third terciles, at around 13.9%.

The sensitivity of CEO turnover to relative share price performance is very pronounced among the SMIM companies and somewhat pronounced among small-cap companies. By contrast, Figure 7 suggests that it is not operational among SMI firms. This is somewhat puzzling and may raise concerns. One should also note, however, that the consequences to an SMI CEO, if there is a turnover, are, in Swiss Franc terms, substantially more severe than for an SMIM or a small-cap CEO because SMI top management compensation is much higher than for SMIMs or small caps. Thus, even where probability is relatively small, chance can have substantial incentive effects. Moreover, additional analysis, not shown in the figure but available on request, shows that SMI CEO turnover is actually very sensitive to operating performance, that is, internal performance measures. Specifically, in the

lowest tercile of industry-adjusted return on assets (ROA), a CEO turnover occurs with 22% probability in SMI firms, while in the highest tercile it occurs with only 12% probability.

Figure 7 also shows that financial-services firms exhibit a somewhat higher turnover-performance sensitivity than companies in other sectors. For example, in a poor performance year, the turnover probability is 23.9%, more than ten percentage points higher than in a strong performance year.

For companies, our advice is to plan ahead actively for the possibility of a CEO turnover (and indeed also of other executives). With high probability, a board which serves for six years, say, will experience at least one CEO change. Every company can be hit by a storm and boards are sometimes forced to find a more suitable CEO if circumstances change. Besides grooming an appropriate pool of potential successors, a central task of the remuneration and governance committee(s) is to have a clear policy in place on, for example, how unvested shares will be treated before a turnover occurs. The disclosure of compensation and the preparation of both prospective and retrospective say-on-pay votes can be significantly affected by CEO turnover, depending on the voting regime in place.

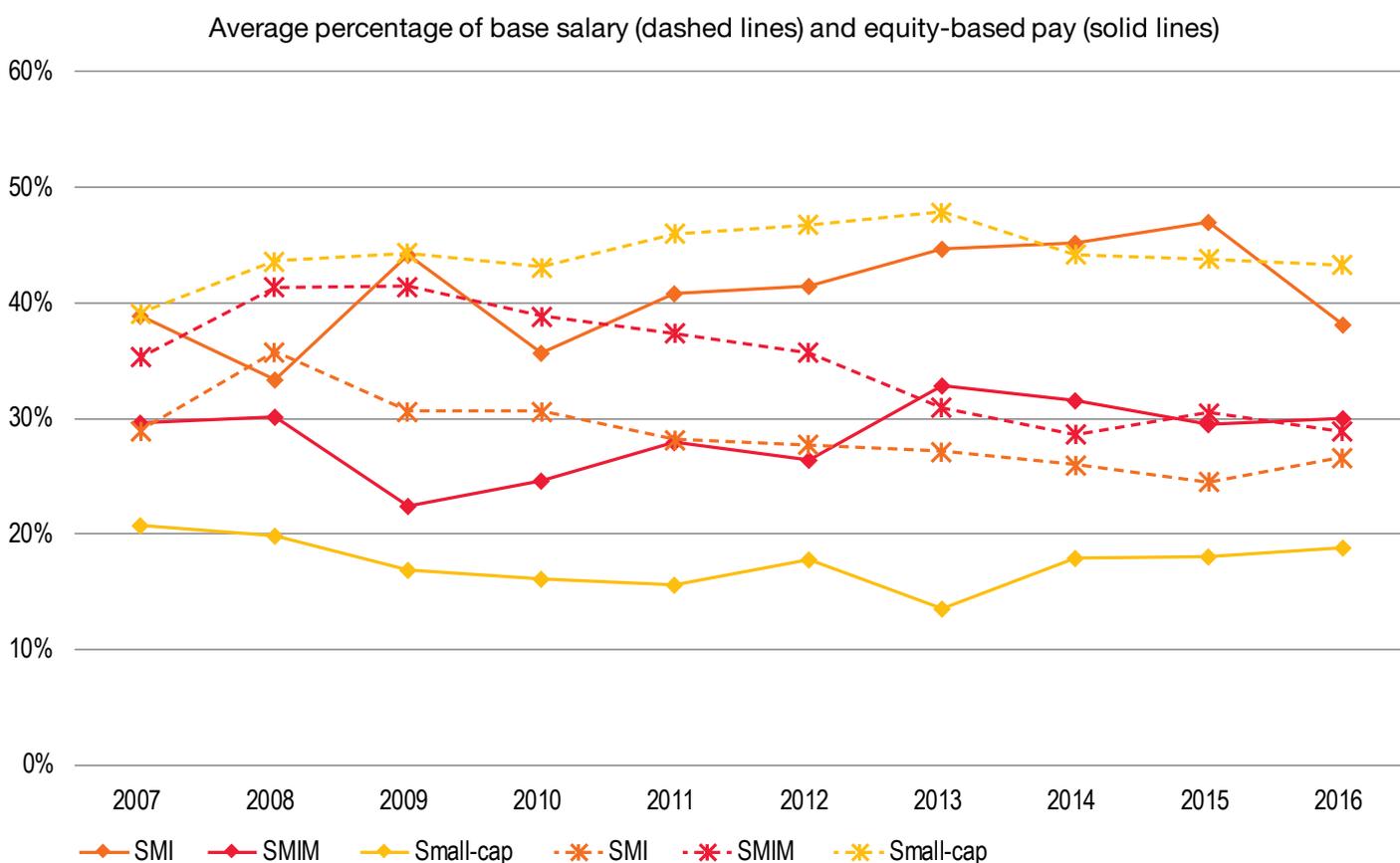
Equity exposure of executives – the wealth lever

A third pay-for-performance channel derives from a wealth effect: CEOs who hold a substantial equity stake in their firm are directly exposed to changing shareholder value. CEOs acquire equity either through compensation or by buying shares (voluntarily or due to shareholding guidelines).

As for compensation with equity, Figure 8 shows the development of pay structure over time. In SMI companies, over the years base salary has rarely accounted for more than 30% of the total, the equity-based element never less than 30% (and often close to, or more than, 40%). Indeed, the average percentage of equity-based compensation has been increasing steadily from around 36% in 2010 to 48% in 2015, though it has fallen to just below 40% in 2016. As

of now, it is not clear whether this is a temporary dip or the beginning of a more long-term shift in pay structure. In SMIM companies, from 2008 to 2012 base salary (around 35–40%) was a much more important component of compensation than equity-based compensation (around 25%). But these companies, too, are tending towards increased use of equity-based pay for their CEOs. As a consequence, in 2013 to 2016 equity-based pay and base salary both represented around 30% of total compensation. In small-cap companies, equity-based compensation is still at a low level, less than 20%, and has not increased noticeably over the study period. Here, as a rule more than 40% of total compensation derives from base salary.

Figure 8: A higher fraction of compensation is given in the form of equity in larger than in smaller firms



As for executive share ownership, shareholding guidelines are more frequent among large-cap companies than among smaller firms. For example, in 2015, 14 out of 20 SMI companies had shareholding guidelines for their executives, but only 5 out of 27 SMIM companies had such guidelines. For board members, 6 out of the SMI companies had guidelines, and only 2 of the SMIM companies had guidelines.

To assess the importance of wealth incentives, we compute, for each CEO, the ratio of wealth to base salary. Figure 9 plots the median of the resulting ratios in the three size groups. In interpreting the results in this section, it is important to keep in mind that the numbers reported here include all shares reported by the companies as shareholdings; they do not include options.

Figure 9: The wealth lever has increased substantially over time, indicating strong exposure of CEO wealth to shareholder wealth

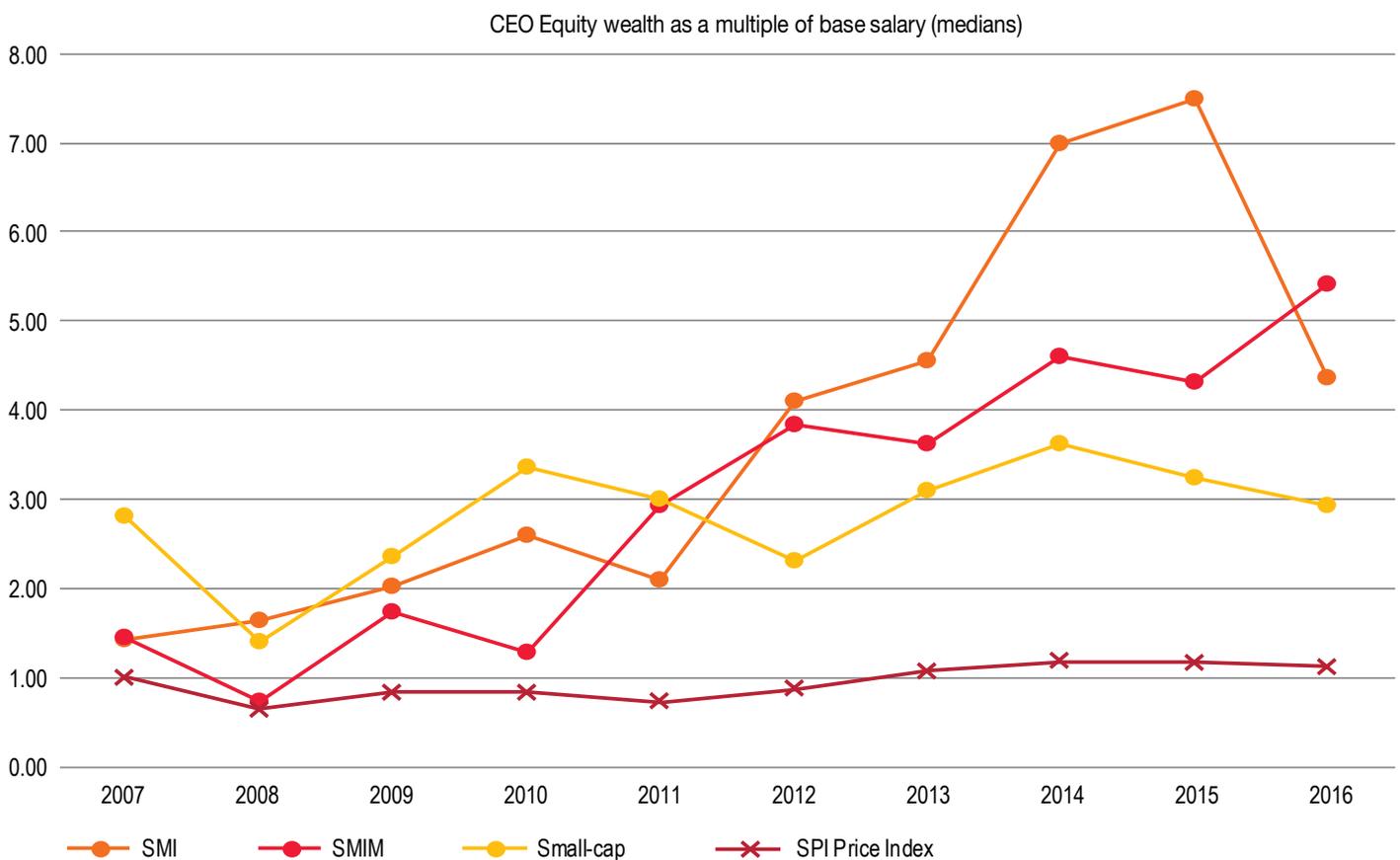


Figure 9 shows that, consistent with international trends, Swiss CEOs of large companies are holding increasing multiples of base salary as equity. While in 2009, the median ratio of equity wealth to base salary was around 2 for both SMI and SMIM companies, respectively, this ratio has increased to 4 and 5, respectively, in 2016. In 2015, the ratio had been above 7 for SMI companies, but it has fallen in the last year. This observation is partially driven by the small number of

observations, so should not be overinterpreted. Interestingly, in small-cap companies, equity ownership has been relatively stable throughout the sample period. The graph also shows the development of the SPI price index, which is normalised to 1 for the year 2007.¹ The graph suggests that the general development of the stock market explains relatively little of this overall development for SMI and SMIM companies.

¹ For this analysis, the price index, not a total return index is relevant. We compute a version of the index which allows one to compare from year to year the increase in the general stock market value, that is, each year, we add the percentage point change of the current year to the index level of the previous year. This is not a buy-and-hold strategy from 2007, which would not be the appropriate comparison for this analysis.

Summary part 2 and outlook part 3

In sum, several channels contribute to an alignment of executive pay and performance: direct pay-for-performance (variable compensation; “bonuses”), greater job stability in response to stronger performance, and the wealth lever. Not all channels are operating at all times, but a board needs to have an overview of the mechanisms at its disposal. It should do so both (a) for internal management purposes as well as (b) in external communication.

Internally, we recommend that compensation committees and boards adopt a holistic view, rather than one narrowly focused on “bonuses”. As our analysis demonstrates, other factors – the turnover-performance sensitivity, or the wealth-performance

sensitivity – may well be quantitatively more important. Our experience suggests that companies should make sure that they do not spend an inordinate amount of time on fine-tuning the specifics of the yearly incentive programme, when the implicit incentives due to other sources receive much less attention.

Externally, too, a holistic value reporting and communication with stakeholders allows for – and indeed requires – a broad, overall picture of how the board assesses executive performance, and how it uses the various channels of securing alignment.

The analysis here raises broader questions: How should an effective incentive system be designed? How should it be communicated? Find out about our views in PwC's Executive Compensation and Corporate Governance Insights 2017, part 3.

Insights 2017 - part 3

Executive Compensation & Corporate Governance



A study examining compensation in SML, SMIM and small-cap companies as well as trends in corporate governance



www.pwc.ch/exco-insights

Insights 2017 - part 3

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Introduction ExCo Insights 2017, part 3

The first part of ExCo Insights 2017 summarised the key highlights for the largest 100 Swiss listed companies regarding the level of compensation, in different industries, of CEOs and other executives, as well as chairmen and other board members.

The second part studied pay-for-performance in Switzerland. Exploiting the long time period and the large sample, that part showed that, contrary to some recent claims, a working pay-performance relationship exists in Swiss companies, and it highlighted the sensitivity of CEO turnover to performance.

In this third and final part, we discuss new methods of pay design and communication with shareholders (and we clarify some misunderstandings regarding established “best” practices). Moreover, we recommend that board members and executives take a broad view of governance matters. We offer the following “Rethinks”:

1. Compensation design is fraught with “best practice” approaches that are actually often not appropriate. Companies should recognise the drawbacks of popular high-powered incentive systems with caps, should reflect on possible unintended side effects of the apparently intuitive use of “relative performance evaluation” (RPE, such as benchmarking to indices), should be wary of the risk-taking incentives of currently fashionable performance shares, and should consider using debt to complement standard equity-based incentives. Simplification – for example, granting straight-up shares rather than complex instruments such as performance shares – also has important advantages.
2. Ongoing communication with shareholders throughout the year, not just ahead of the Annual General Meeting (AGM), is essential to build trust and understanding regarding a company’s specific situation. This is particularly important given that a company also has to deal with powerful proxy advisors who sometimes use checklists and policies that management may regard as inadequate in the context of the concrete challenges a company needs to solve with incentive systems and governance choices.
3. We introduce the 5 Rs of value generation through effective governance: Recruit (select and retain the right board members, executives and employees), Reward (design and live incentives), Report (engage in value reporting and communication), Realise (execute value generation), and Rethink (reflect critically on practice of all four of the other Rs). An effective board has a holistic view of all of these matters. The weakest link of these five elements will determine the overall performance of the company.

Rethinking the shape of incentives: some fundamental considerations

Every now and then, it is worth stepping back to consider why and how we can incentivise individuals optimally in a theoretical benchmark. Indeed, the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2016 (also known as the Nobel Prize in Economics) was awarded to Oliver Hart and Bengt Holmström for their path-breaking work in contract theory. Their analysis of optimal incentives is motivated by a moral hazard problem: a principal (for example, shareholders) cannot contract on effort with an agent (for example, the manager). For example, effort may be unobservable. Therefore, the principal writes a contract with the agent which gives the agent a pre-defined compensation level (“incentive”) for each outcome level, knowing that the outcome stochastically depends on effort. “Stochastic” means that there is no definitive relationship between effort and outcomes, but luck (good and bad) does play a role in determining outcomes. For example, whether customers ultimately like a product will affect sales in addition to the extent to which the sales manager tries hard to sell the product. The uncertain link between effort and outcomes is reflected in the usual terminology referring to, for example, sales as a key performance indicator.

How should incentives depend on delivered outcomes? The fundamental analysis of optimal incentives shows that, in general, an incentive scheme cannot be decreasing in outcomes at all outcome levels. For example, imagine for simplicity that there are only three possible outcome levels, Bad, Middle, and Good. Then, the general theory (only) says that we cannot have an optimal incentive scheme such that the bonus for Bad is higher than the bonus for Middle, which is in turn higher than the bonus for Good. But this statement does not imply the incentive scheme would be increasing in outcomes at all outcome levels (which would mean that the bonus for Good has to be higher than the bonus for Middle and that the bonus for Middle in turn has to be higher than the bonus for Bad)!¹ This statement is likely to give pause to most readers: does this not contradict what practitioners regard as “obvious”, namely, that stronger results should always go hand-in-hand with higher incentive payments?

Indeed, the finding is surprising. But it becomes clear when one recognises that sometimes, outcomes do not have a simple one-to-one relation with effort. In such instances a non-monotonic compensation scheme (where bonuses may, for example, be higher for top and bottom outcomes than for intermediate outcomes) can be optimal. For example, continue the example from above and imagine for simplicity that there are only two effort levels, High and Low effort. Also suppose that when effort is High, the probabilities of Bad, Middle, and Good are 0.4, 0.1, and 0.5, respectively. And when effort is Low, the probabilities are 0.5, 0.5, and 0. This scenario does not seem extraordinary or pathological. Economically, what it means is that when the manager works hard, there is a good chance to achieve the best outcome, but failure may also occur with relatively high probability because perhaps the manager has pushed too hard (“crash and burn”). In such situations, optimal incentives can be that bonuses are highest when the outcome is Good, and lowest when the outcome is Middle. Intuitively, when the outcome is Bad, it is almost as likely that the manager chose high effort as low effort. Therefore, the principal would not want to punish the agent for low outcome realisations. Of course, whether this will overall be optimal will depend on “how bad is Bad”. In general, one should expect higher bonuses for higher output across the range of outputs if and only if lower outcomes systematically indicate a lower effort choice by the agent.

Assuming for the moment that we do have a situation where higher effort leads to an increased likelihood of higher outcomes by the agent throughout, what should the shape of incentives be? Theory has no predictions that an incentive system should in general be linear in outcome levels (even though this clearly has practical advantages in terms of simplicity). Basic principal-agent theory also does not predict upper limits (“caps”) on pay. Nonetheless, in practice, many performance schemes are linear, and they do have caps and/or areas where no bonus is paid. It is worth reflecting on what these features imply.

¹ Note that only in the special case when there are only two performance levels, the statement “not decreasing” is equivalent to “increasing”. But with more than two performance levels, this does not hold anymore.

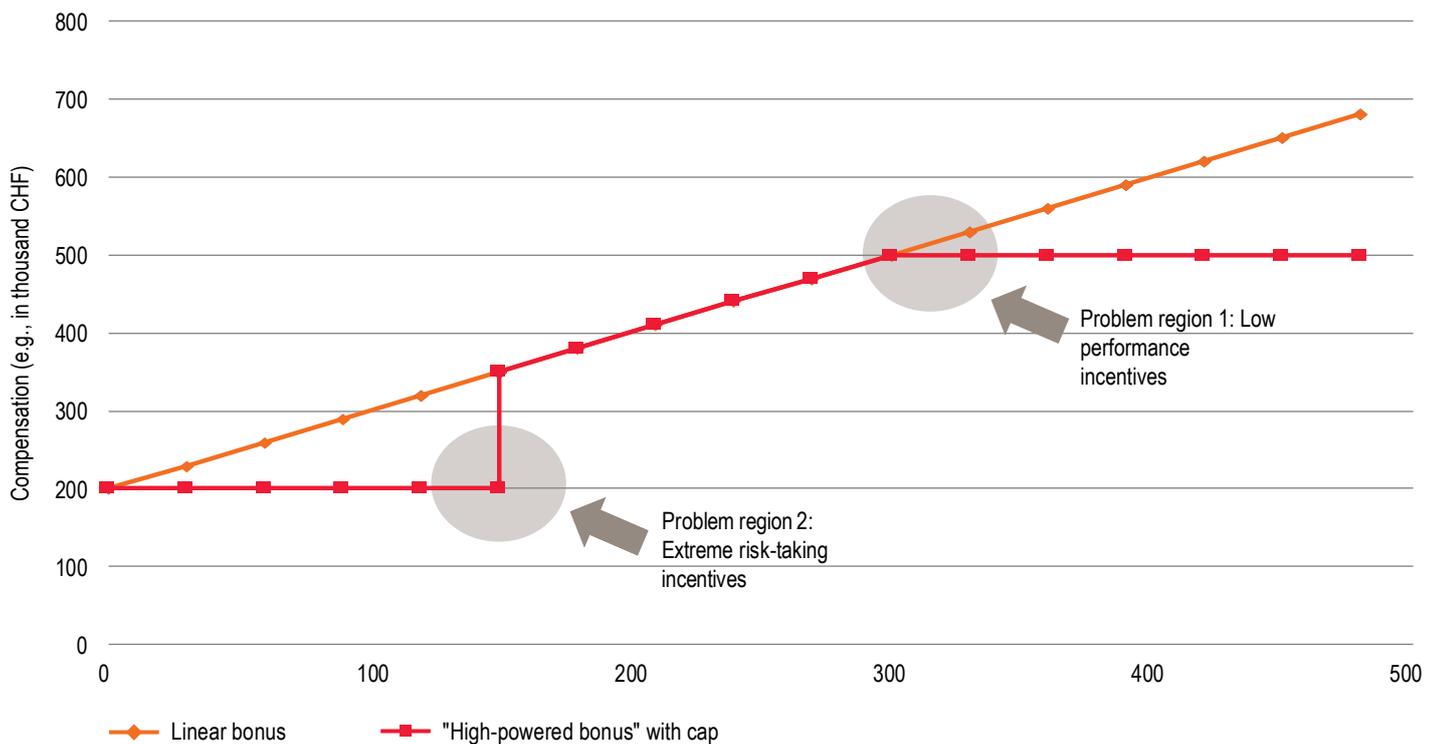
Figure 10: A standard bonus scheme leads to unintended side effects

Figure 10 helps with this task. This figure plots a typical incentive plan that, for illustration simplicity, takes one key performance indicator (KPI, e.g., sales growth) as an input. As is often the case in practice, the scheme is linear (though this is, as mentioned above, not generally optimal). The executive receives some fixed compensation (CHF 200,000 in this instance), and no bonus, unless the KPI achieves a minimum of 150. Companies like to describe such a bonus scheme as a high-powered incentives scheme, or as a bonus scheme with “stretched goals”. Shareholders and some proxy advisors often respond favourably to such an incentive plan. Companies also tend to recognise that an unlimited bonus on the upside can lead to newspaper headline risk. They, therefore, put in a cap (maximum), here shown at CHF 500,000.

There are two problems with this system: first, in problem region 1 indicated in the figure, incentives for additional performance are reduced. “Budget games” begin: for example, when an executive has, in September, reached the performance level that secures the maximum bonus for the year, he or she will try to “save” output for next year. Problem region 2 is even more tricky. Practitioners often worry that the flat region is “incentive-free” because even a move from 110 to 130 on the KPI does not result in a higher bonus. However, in fact, that region offers extreme incentives – but not necessarily “good” performance incentives, but rather extreme risk-taking incentives. An executive has an enormous incentive to essentially try anything to get the KPI to a point where the bonus “kicks in”. This system, while very popular, thus requires investments into safeguards against excessive risk-taking – and having these safeguards may ultimately prove very costly.

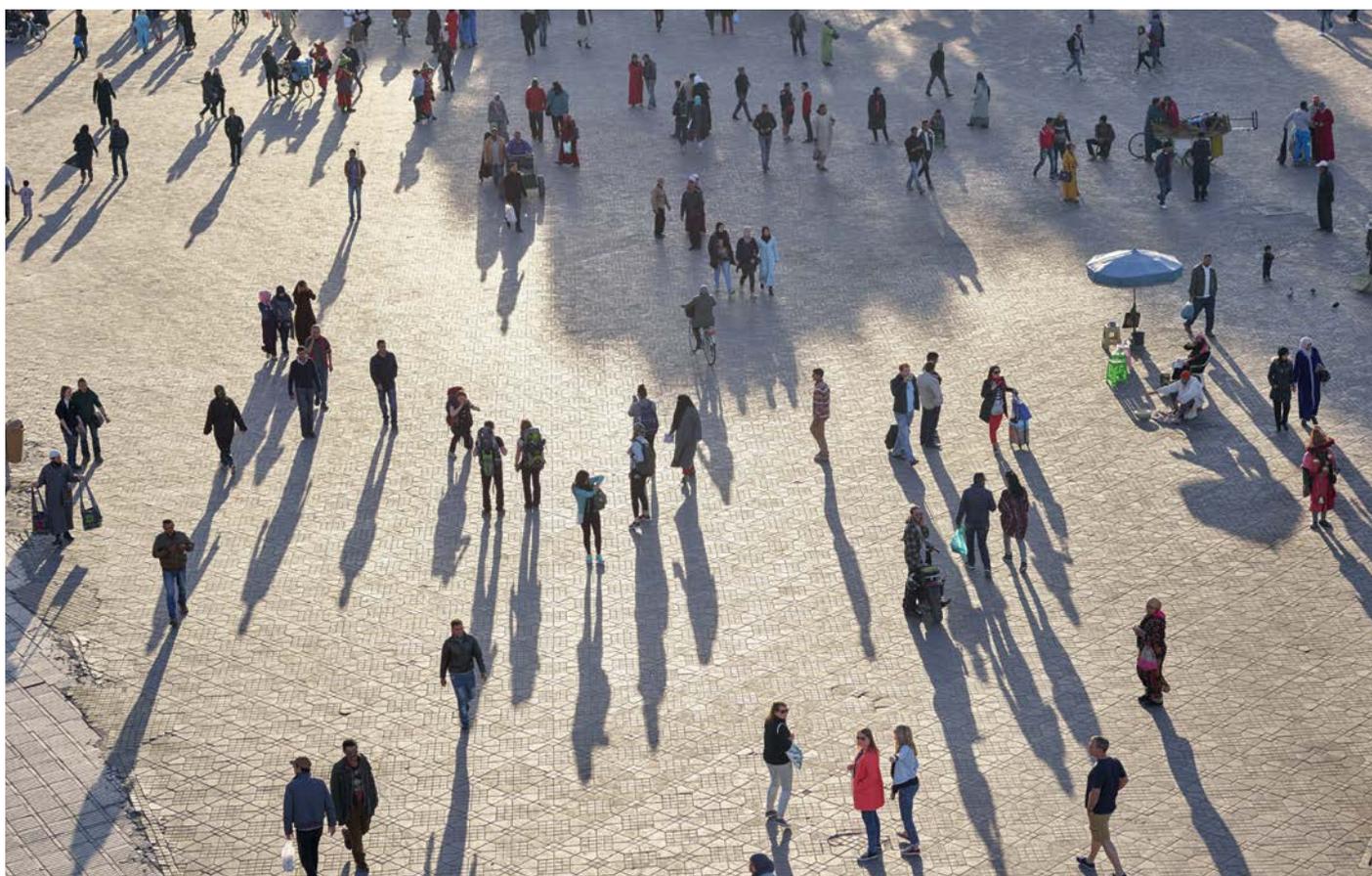
Rethinking the framing of the incentive system

Incentive design can implicitly leverage another fundamental insight from the interaction of economics and psychology. Richard Thaler received the 2017 Nobel Prize for his work on behavioural economics. The “endowment effect,” a term coined by Thaler, describes the observation that a good often appears to be more highly valued when it is part of an individual’s endowment, compared to when it is not. How might we employ this effect in compensation design? To see this, consider the following two incentive plans, building for simplicity on the symmetric linear incentives plan in Figure 10.

Plan A: the manager receives a base salary of CHF 200,000 and a linear bonus of CHF 1,000 for each unit of the KPI. For example, when the manager reaches a KPI of 250, he or she gets a bonus of CHF 250,000 and, thus, total compensation of CHF 450,000.

Plan B: the manager receives a target compensation of CHF 450,000 that is conditional on performance at KPI = 250. For each additional unit of the KPI, the manager receives CHF 1,000, but for each unit of the KPI he or she falls short of the target of 250, his/her compensation is reduced by CHF 1,000.

Economically, the two scenarios are identical, but they are framed differently. Behavioural economics predicts that Plan B is likely to induce much stronger incentives, because the starting point (“endowment”) is CHF 450,000, and the manager will work particularly hard not to lose this endowment. Moreover, in terms of communication, Plan B in fact has the advantage that it essentially offers not only a bonus, but also a malus system. This makes it clear to shareholders that poorer-than-expected (or required) performance in fact leads to a reduction in pay (not merely to a somewhat less high bonus than usual). Some, but too few companies use this insight in the design of their reward systems.



Rethinking relative performance evaluation

Continuing with theoretical insights out of Hart's and Holmström's Nobel-Prize winning work (2016), according to the informativeness principle, an incentive scheme should "filter out" externally observable information and should not use performance signals whose information content is subsumed by other signals already in use. What this means is, first, that the common practice of having "balanced scorecards" for the determination of short-term incentives has to be questioned. In our experience, the scorecards indeed often contain overlapping (and sometimes simply too many) performance indicators. Simplification and checking whether one can reduce the number of indicators would be important steps for many companies.

Second, a powerful implication of the informativeness principle is that incentive payments should recognise that good performance of a company may be due either to (observable) general industry or market trends, or due to company-specific performance (that is due to particular manager skill or effort). According to this theory, only the latter type of performance should be rewarded. This idea of "relative performance evaluation" (RPE) is extremely useful and influential. It offers an incontrovertible insight within the model framework in which it is derived. RPE even appeals to everyday intuition that managers should not be rewarded for good luck. Who could reasonably disagree with this view? The approach is being sold by some compensation consultants as a "solution" to incentive problems.

We, by contrast, caution that the adoption of relative performance incentives also brings with it several challenges and disadvantages. First, most observers are somewhat disappointed when they learn that the system also implies that managers would also be protected against bad luck. This is inherent in the system, yet it can be hard to explain ex post that a manager receives a high bonus because performance at the company was minus 30%, when the rest of the industry performed at minus 40%, leading to relatively excellent performance (and thus high pay) of the manager.

Second, relative performance evaluation can lead to excessive risk-taking, especially when the system is calibrated, as it often is in practice, to reaching a certain minimum position in a comparison group. Essentially, the same problem as in Figure 10 can arise in that case.

Third, a reward system's role is not only to incentivise, but also to attract and retain. If competitors in the industry are doing well and are therefore able to offer higher compensation, it would be difficult for a firm to tell its executives that common industry developments will be completely "filtered" out, as it would then not be able to offer commensurate compensation.

Fourth, in practical terms, RPE can all too easily be undone by executives. Imagine a bank CEO whose compensation depends on own share price performance relative to a broad industry market index. Economically, the executive is long his own bank's performance and short the index. The executive can simply undo this exposure by buying the index. The bank may try to forbid such hedging. But it is simply unrealistic to imagine that this is perfectly feasible. Even if the CEO is not allowed to buy the specific index that is being used for RPE (or if such an index is tailor-made and thus not available on the market for trading), he can buy a sufficiently correlated product, such as an aggregate market index. Disallowing the CEO to have any engagements in the stock market whatsoever seems impossible, or exceedingly costly.

Fifth, policy-makers should also be wary of relative performance evaluation. Consider two banks. Suppose managers of the banks are being evaluated according to performance relative to the other bank (or, more generally, relative to the banking sector). Would such managers have an incentive to take (asset) risks (such as engaging in a line of business) that are highly correlated with what other banks are doing? The answer is a resounding yes. By doing what others are doing, the manager reduces his or her risk exposure. Interestingly, such an action is in the interest of the shareholders of each individual bank: when the compensation of the manager becomes less risky, the expected compensation that needs to be paid to the manager is reduced (a standard result, given that the manager is risk-averse). What will happen, therefore, is that both banks will tend to invest in quite correlated, similar activities. In other words, RPE may induce systemic risk.

In sum, these considerations show that the simple recipes that some consultants and observers have in their toolbox may work in some instances but may, in other circumstances, not only be ineffective but counterproductive and potentially dangerous for the economy.

Rethinking risk-taking incentives

“Strong incentives” sound like a positive thing to most observers. Unfortunately, what sometimes gets forgotten is that incentives to achieve high performance tend to come along with incentives to take risk as well. Sometimes, this risk is desired, but sometimes it is excessive. It is tricky to tell apart (before the outcomes happen) what is “good risk” and what is “excessive risk”. However, board members and executives should understand the risk incentives implications of commonly employed incentive systems. We have highlighted this issue already with respect to the “high-powered bonus system” above. Here, we focus on another practically relevant issue, the risk-taking incentives inherent in equity-based compensation plans.

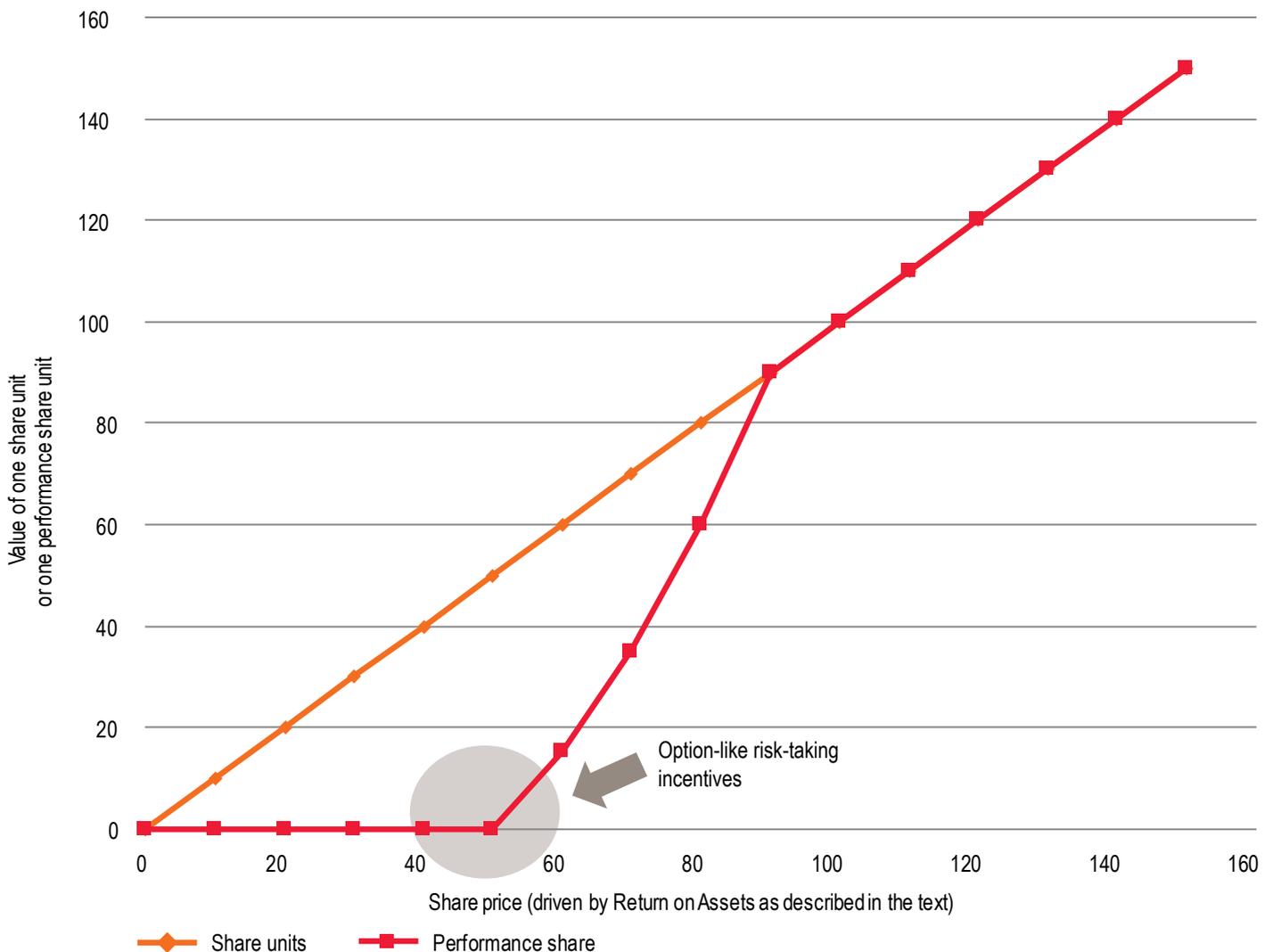
Figure 11 shows the value at the time of vesting of a standard share plan and a performance share plan. Restricted stock units vest after the service condition is fulfilled. A share unit’s value is shown with the solid line: it is simply worth the stock price. For the performance share plan, assume a typical performance vesting condition: suppose that no stocks vest if the performance condition is not met at all; 25% of the grant vest if 25% of the performance condition is met; 50% of the grant vest if 50% of the performance condition is met; and so on. At 100% of the goal, the full stock amount vests. Suppose that currently the stock price is 50, and ROA is 6%. But this is seen as too weak a performance by the board. Thus, the plan foresees that if ROA of 6% is obtained, no shares should vest. By contrast, if ROA is 10%, the board deems this strong performance, so that all shares should vest. (There could be vesting even higher than 100% for even better performance, but this is not needed to make the point here.) In between, linear vesting takes place. Presumably, the stock market would pick up on how things stand at the company. Therefore, if ROA

increases, the stock price will be higher. In the graph below, assume, for simplicity, that every percentage point increase in ROA is associated with a stock price increase by 10. Thus, going from ROA of 6% to 8%, the stock price goes from 50 to 70. At the target, ROA = 10%, the stock price is 90.

The figure shows that what performance shares in effect do is to create an option-like payoff in the currently relevant area of performance (stock price 50, ROA 6%). At very high performance (here assumed to be ROA 10%, implying a stock price of 90), the payoff profile actually becomes concave, and then turns linear.

The analysis so far compares one straight-up share unit with one performance share unit. If one wants to compare risk-taking incentives implied by a package that costs the firm a given amount for accounting purposes, one also needs to consider that if performance share units are valued at fair value (rather than at face value), the executive will receive a larger number of performance share than share units for the same total value of the compensation package. This further induces higher total risk-taking incentives. (This observation extends the general principle that to maximise incentives for a given cost, one can give management deep out-of-the-money options.)

In our view, straight-up shareholdings – fostered by appropriate shareholding guidelines – can provide sufficient incentives without giving rise to the side effects of performance shares. Another advantage is that the incentives of shareholdings, and the cost to shareholders of giving out shares, are very easy to communicate.

Figure 11: Performance shares induce strong risk-taking incentives

As shown in part 2 of ExCo Insights 2017, equity-based compensation is prevalent (and, seen over several years, broadly on the rise) in SMI and SMIM-companies, but less prevalent (and more or less stable) in small-cap companies. There are clear advantages to use equity-based compensation when it comes to aligning managers with shareholder welfare. However, debt-based incentives can help with balancing out the risk-taking incentives from equity. When a manager is partially compensated with debt, he or she will also consider downside risks. Compensating with debt sounds unusual. Nonetheless, in the US, this is a very common compensation tool, at least implicitly, as pension promises by firms tend to be subject to the firm surviving, that is, in case of bankruptcy, managers stand in line with other creditors to be paid back. In Switzerland, this is not typically the case. However, some banks have implemented explicit debt-like instruments for their executive management. But there are ways of

implementing debt-based compensation more generally. For example, for firms that have public bonds outstanding, these bonds can be used to convey part of a base compensation or a bonus payment (in addition to conveying part of the bonus in cash, or equity, or a combination of the two as usual). For large firms with traded Credit Default Swaps (CDS), one can use the value of CDS spreads to construct a compensation scheme. Finally, most directly, instead of the company giving a loan to management (which is allowed within the bounds set by the Articles of Incorporation for companies subject to the Swiss rules), management can give a loan to the company. This expands the logic of deferred bonuses, but makes the notion that the management is a creditor of the company both legally and economically more explicit. A board should consider the broad range of tools at its disposal to develop an overall balanced incentive system.

Rethinking communication with shareholders and the role of proxy advisors

Shareholders are unhappy with pay-for-performance disclosure performance in Switzerland. This can be seen in recent survey evidence: in a 2017 survey of 146 market participants (83 Swiss issuers, 36 asset and fund managers, 27 pension funds), SWIPRA found that only 3.6% (5.9%) of Swiss (international) investors said that they were satisfied or very satisfied with pay-for-performance disclosure.² In the largest 100 Swiss companies, the percentage of “against”-votes in advisory votes on remuneration reports has increased from around 6% in 2014 to around 12% in 2017. Overall, for too many issuers pay-for-performance disclosure receives too little attention.

The survey also suggests that important communication is occurring during the year, not just ahead of the AGM. Thus, while in the past a well-written compensation report was sufficient for ensuring that a company had done what it could on compensation matters, today this is just a necessary condition.

Among international investors – which are becoming increasingly important for Swiss companies as their holdings are continuously increasing – 80% of international survey respondents said that after an engagement with a company, they are likely to become more supportive in their voting behaviour. This makes sense as it is only through engagements that companies can lay out the specifics of their viewpoints. In fact, engagement is critical also because investors state that they do not primarily get information about the company from the information provided by the company in reports, but rather from two other sources: from the direct conversation with the company ... and from proxy advisors.

Substantial concerns have been raised about the influence of the proxy advisors on governance. Internationally, there is a tendency towards regulation of proxy advisors. For example, in the US, a bill was drafted in June 2016 to require proxy advisory firms to register with the Securities Exchange Commission (SEC). Such registration would require proxy firms to provide annual financial reporting, disclose conflicts of interest, codes of ethics, methodology for the formulation of voting recommendations, and to provide adequate opportunity to respond to draft recommendations (with an ombudsman to mediate any issues raised by companies). The bill has, however, met resistance among proxy advisors and investors.

In Switzerland, in June 2017 SIX Exchange Regulation opened consultations on the proposed introduction of an obligation to disclose advisory relationships between issuers and proxy advisors. The overwhelming majority of those who participated in the consultations were in agreement that the increasing importance of proxy advisors creates a need for rules on potential conflicts of interest affecting those proxy advisors. However, the proposal was rejected specifically by those representing issuers' interests. Among other arguments,

they tended to take the view that any transparency regulations should apply to the proxy advisors themselves, rather than issuers. Because SIX is not responsible for regulation of entities other than issuers, they have for the time being not pursued this regulation further.

Companies have to deal with the reality that proxy advisors such as ISS and Glass Lewis are powerful. We have regularly heard company representatives complain that they are being treated unfairly and that in particular ISS has too junior analysts who do not understand the business, is not open to dialogue, and/or uses in some issuers' view inappropriate methods (both in terms of the analysis of the company, but also in terms of the business model, which entails offering consulting services for companies who often feel that they have a choice between buying the offered services or risking an against-recommendation). Whether or not these complaints truly apply, we believe that the most reasonable course of action for companies is to lead an ongoing dialogue with their main investors throughout the year. We recommend that companies enter stakeholder engagement conversations with a concrete strategy and a properly prepared Q&A that allows them to inform shareholders of why they are doing what they are doing (not merely disclosing what they are doing). This should include any rationale for changes, rigorous understanding of the design features and possible pay outcomes in both positive and negative performance scenarios (including extreme outcomes), and clear responses to anticipated questions, particularly those that have been raised previously by proxy advisors or investors.

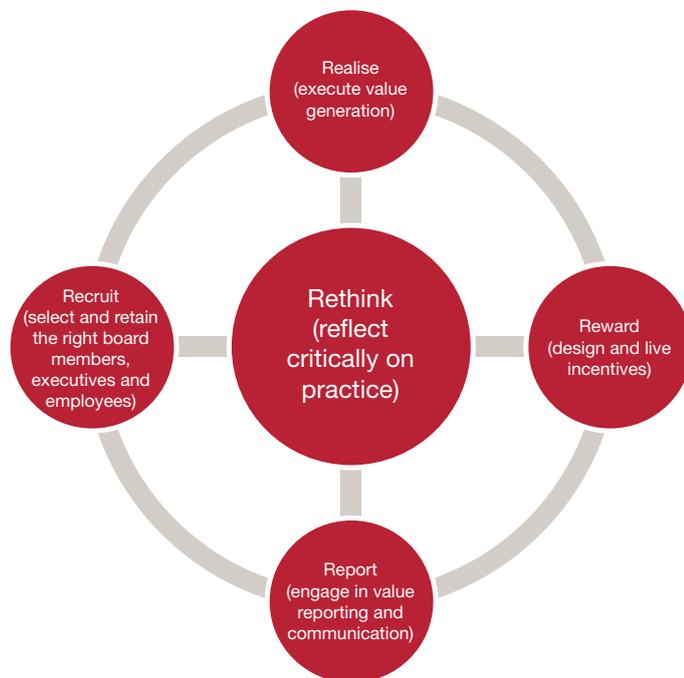
A tension that companies have to live with is that customised remuneration models are, in principle, preferable to off-the-shelf, “best practice” models (which, by definition, cannot fit the situation of a specific company), but that bespoke, actually fitting models may be more difficult to communicate. There are some instances where that tension can be easily addressed: for example, we do believe that by and large a reduction of complexity serves both goals, a better-working reward system, and a system that is more easily explainable. However, there are instances when the conflicts cannot be easily resolved. For example, some proxy advisors and investors strongly favour performance shares. By contrast, as we noted above, we have long regarded the use of these instruments as rarely optimal and often dangerous. Indeed, recently even some large investors like the Norges Bank Investment Management have uttered a preference for long-term (10-year) restrictions on stock, rather than performance shares, also in the spirit of a move away from complexity in incentives towards straight-up co-ownership by management. But there is no single optimal solution. Deciding which aspects to weigh more is not easy, but this is what it means to lead an organisation.

² See www.swipra.ch/survey

The 5 Rs of value generation through effective governance and compensation design

Compensation design is one important element of effective governance. Our work emphasizes, however, the overall view of governance in a company. To visualize the key building blocks, we introduce the 5R framework depicted below. This is a “weakest link” setup: Each of the elements is essential, and they do not occur in a particular order.

Figure 12: The weakest link of the 5 Rs will determine the performance level a company can reach



Having the right board members, executives, and employees is absolutely essential for a company. Securing the needed competencies but also the values that fit with the company is critical. Hence, “Recruit” is a central building block.

“Reward” is in many ways the core topic of the Insights that you are reading at the moment. Designing a reward system for attraction, retention, and incentives is a difficult but essential task. Despite – or because of – the market fluctuations we have seen over the past years and the many new regulatory challenges companies face, we continue recommending that executive compensation is designed with six simple principles in mind, see Box 3. It is important that the reward system does not only “look good on paper”, but that all participants actually live according to it.

Value reporting is an important value driver in its own right. “Report” in fact means two-way communication, listening to shareholders. Better value reporting can lead to more trust (and, thus, lower cost of capital) as well as to better understanding inside the company (and, thus, to better resource allocation decisions).

The ultimate purpose of a company is to generate value. All the best intentions and plans do not count for much if they are not put into action. Therefore, “Realise” is a key rubric. Advice by consultants is only of limited benefit here. Execution and actual delivery of performance remain the core domain of excellent managers.

Finally, we hope that this document and our other publications help you with the “Rethink” that is continually needed.

We look forward to working with you to support you where needed.

Box 3: Six principles for compensation design

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 not needed in well-balanced compensation systems.
5. An effective compensation system establishes entrepreneurial incentives.
6. An effective compensation system focuses on value created for the long term.

