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Executive Compensation & Corporate Governance

Insights 2018 – Part 3

A report proposing new methods of pay design and communication

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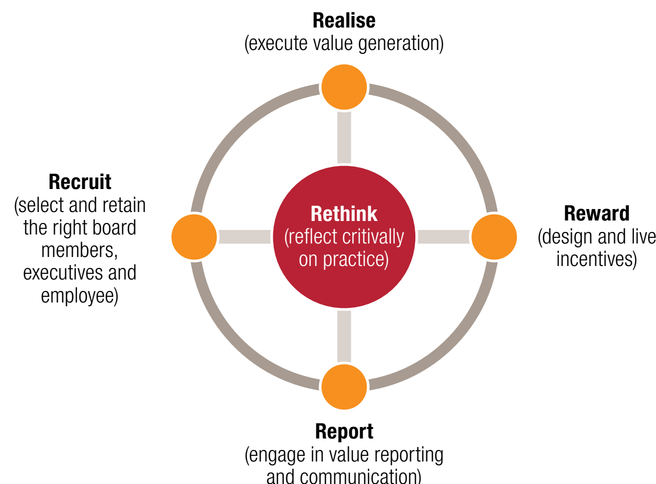
Introduction Insights 2018, part 3

In the Insights 2017, we introduced 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). As we argued then, an effective board and a value-oriented executive management has a holistic view of all of these matters.

Figure 1: The 5 Rs of value generation through effective governance and compensation design



Of course, among the 5 Rs, "Realise" is a key rubric. Execution and actual delivery of performance remain the core domain of excellent managers. However, without the other elements, something is missing, too. The Insights 2018, therefore, contribute towards strengthening several of these other elements. In particular, the first part of ExCo Insights 2018 summarised the level and structure of compensation of CEOs, other executives, chairpersons, and other board members in Swiss listed companies. The second part offered, for the first time, a comparison of the level and development of executive and board pay in Switzerland and Germany. Both of these parts thus help board members and executives Rethink the Recruit and Reward elements.

In this third and final part, we focus even more explicitly on the Rethink element. We discuss new methods of pay design and communication, thus contributing in particular to both the Reward and Report components.

The key ideas developed in this part are the following:

1. Discussions around remuneration are typically static, that is, they are restricted to one year at a time. However, when dealing with a dynamic issue such as securing sustainable business performance, a dynamic approach is required.
2. We present a simple strategic stock allocation concept for variable remuneration, referred to as STARS (**S**tock **A**wards for **R**ight **S**trategy). This is a long-term incentive system that takes seriously the need for rewards for strategic goal achievement. Specifically, the core of this system entails, first, the selection and communication of specific annual targets in relation to the organisation's strategic objectives and, second, using mainly share allocations to recognise the meeting of those targets, with just a relatively small proportion of cash rewards.
3. We also call for explicit analysis and disclosure of changes in the manager's wealth position with respect to company shares. This provides a holistic view of how material outcomes ("pay") and performance are linked. In short: Dynamic disclosure drives dynamic decisions.

Of course, reward systems are not one-size-fits-all. The STARS concept can be adapted to a company's specific situation, but is general enough to be understood and acceptable across all businesses. We look forward to engaging in dialogue with you to understand the specific challenges and needs of your company. Together, we can develop a tailor-made approach for your current situation.

[1] Wagner, A./Wenk, C. (2016), Corporate Governance: Beyond Best Practice, Swiss Finance Institute White Paper. This definition expands on the traditional definition given by Shleifer/Vishny, which focuses exclusively on (financial) capital providers, cf. Shleifer, A./Vishny, R. (1997), A Survey of Corporate Governance, Journal of Finance 52, 737-783.

Corporate governance, company purpose, and shareholder value

A discussion of the design of variable remuneration systems must take account of the basic question of what is the objective of a private company. For this, it is worth taking a broader view of the role of corporate governance. Corporate governance deals with the ways in which suppliers of financial and human capital to corporations assure themselves of getting a return on their investment.[1] This definition considers two suppliers of capital: firstly, the shareholders and creditors (investors – i.e. the "capital providers" in a narrow sense), and secondly, the managers and employees. Members of the first group contribute financial and other material capital; thus, a somewhat wider definition of this group would include (goods) suppliers. The second group supplies human capital. In addition, a third group comprising clients and society in general merits attention. These stakeholders grant the business its "licence to operate".

The stakeholders of each of these three groups expact a return: the investors in a financial form;[2] managers and employees in financial and personal form; society in the form of a commensurate level of product and service quality, responsible use of public goods and creation of jobs.[3] When the satisfaction of one of these groups is not sustained, that group will sooner or later no longer be willing to support the existence of the organisation.

The different groups of suppliers of capital have conflicting priorities. These are most evident and familiar in respect to the relationship between shareholders and managers. When manager actions are not observable, shareholders may worry that managers embark on activities not fully aligned with shareholder welfare.[4] The principal-agent model provides ways in which one can conceptualise an efficient ("second-best") contract between owners and managers to direct managers' actions to the long-term increase of shareholder value. The optimal contract thus establishes an incentive system.[5]

Although incentive systems may put shareholder value in the foreground, the shareholders must (should) also take account of the other stakeholders. If any of the stakeholder groups is neglected, it is not possible to create maximum value for the shareholders. As such, the old dichotomy of shareholder value vs. stakeholder value is actually not a question of either-or. Rather, the maximisation of shareholder value by means of suitable incentive systems must consider also the well-being of the other stakeholder groups, that is, the return on investment for these other stakeholders to ensure they are willing to carry on in their roles.

While even the theoretical analysis of optimal incentive systems is challenging, the suitable practical implementation is even more difficult. There are distorted incentives, incentives that focus managers on the too short term and incentives that promote excessive levels of risk-taking. Frequently, target setting and measurement represents a major challenge for the board and remuneration committee. Furthermore, the complexity of today's systems can be difficult for investors and even managers to understand.

As a result, for example, the Government Pension Fund of Norway, one of the most influential investors in the world, has recently called for a radical overhaul of manager pay, arguing that the long-term incentive systems favoured by many companies are flawed and that long-term incentive programmes involving performance criteria should be abolished. Instead, the focus should be on remuneration models that target high levels of long-term ownership.[6] The system presented in this part 3 of Insights 2018 also postulates participation in shareholder value as a central principle. However, it also recognises the importance of operational targets, linked to strategy, that can be influenced by the management on an ongoing basis and with specific actions. Before delving into the details of this system, in the next section we describe variable remuneration and its location in a dynamic view in more depth.

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[2] We recognise that even capital providers may be "motivated" by non-financial aspects and expect a certain "impact" from their investments.

[3] We do not discuss the role of the media, proxy advisors, rating agencies and (remuneration) advisors in detail, but we note that these players can be quite important.

[4] Jensen, M. C./Meckling, W. H. (1976), Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics 3, 305-360. For an overview of academic work on the principal-agency problem and the resulting theoretical and empirical analysis of executive compensation, see also Gabaix, X./ Edmans, A./Jenter, D. (2017), Executive Compensation: A Survey of Theory and Evidence, in Hermalin, B./Weisbach, M.S., ed.: Handbook of the Economics of Corporate Governance.

[5] In this article we consider monetary incentive systems, but emphasise that non-monetary incentives and social norms also play a large role in the overall context of the firm. When setting incentives, indirect performance incentives must also be considered, such as career concerns. See Insights 2017.

[6] A substantial proportion of total annual CEO remuneration should be provided in shares that are subject to a sales restriction of at least five, preferably ten years. Cf. Norges Bank Investment Management (NBIM), CEO Remuneration Position Paper, 7 April 2017. https://www.nbim.no/en/responsibility/our-voting-records/position-papers/ceo-remuneration.

The importance of a multi-period analysis

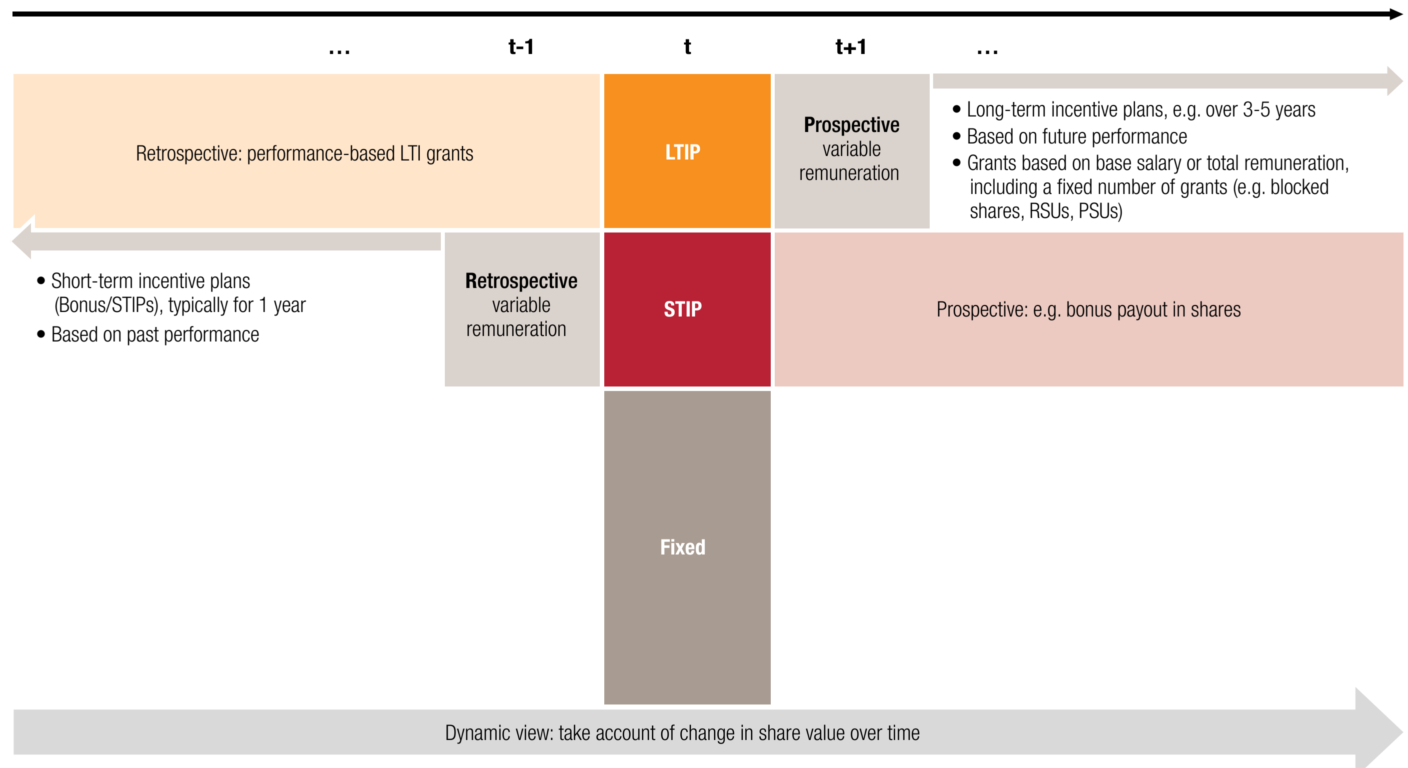
At first glance it appears easy to view variable remuneration as the simple opposite to fixed remuneration, i.e., the base salary or fixed salary components. It is also intuitive that variable compensation should direct managers to act entrepreneurially and allow them to participate in the commercial success of the company. However, despite this fundamentally simple concept, there is often confusion of meaning. Instead of speaking about variable remuneration in general, it can be helpful to distinguish between "remuneration dependent on past performance" (retrospective variable remuneration) and "remuneration dependent on future performance" (prospective variable remuneration). Figure 2 illustrates this point.

At any given time, a manager receives (in addition to a fixed salary and other fixed amounts) both remuneration payments that depend on past performance and elements that serve as an incentive for future performance. The key element of a dynamic analysis is that the "reward" paid out in a given year is the result of incentives from the previous year(s).

It is common to differentiate between short-term and long-term incentive plans (STIPs and LTIPs). Specifically, these are often understood as single-year or multiple-year plans. However, this distinction is misleading or at least limited since even the single-year plans are generally aligned with the value of the company and therefore include a long-term view. In addition, the LTI grant (not only the ultimate payout) may also depend on the achievement of certain performance criteria.

The typical method of disclosing remuneration amounts in Switzerland adds an additional layer of complexity. For example, in relation to LTIPs, it is common to disclose only grant values (in contrast to other countries such as Germany, where the actual amounts paid out are published as well). While a few companies in Switzerland do report payouts from previous LTIPs, they remain the exceptions. In the case of annual bonus payments (STIPs), due to the time frame for the target setting, the bonus scheme is not disclosed at grant but only with the paid amount.[7]

Figure 2: **Retrospective and prospective variable remuneration**

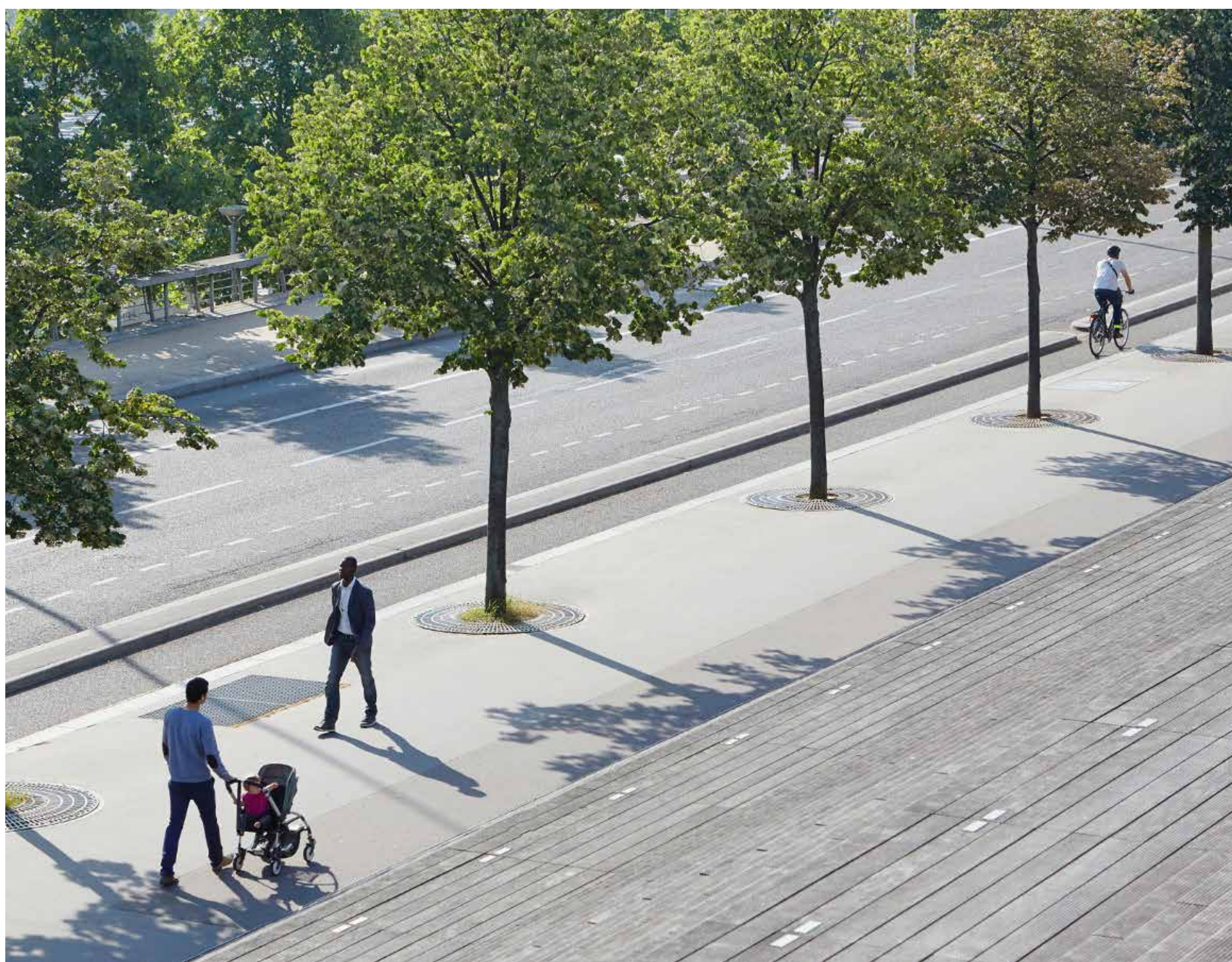


[7] Consider a company where the financial year equals the calendar year. The targets for year t are set in the October of year t-1, for example. The disbursement takes place in February of the year t+1. According to the accrual principle, the remuneration report for year t, which is published in March (for example) of year t+1, shows the (possibly estimated) disbursement made in February t+1 and not the expected value defined in October t-1.

The form in which the bonus is delivered also plays a role. Where previously bonuses were paid exclusively in cash, nowadays managers receive part (or all) of the payment in (blocked) shares (i.e. shares subject to a sales restriction). This blurs the lines between short-term and long-term incentive plans. Payment in the form of shares is normally motivated by the right idea – alignment with long-term corporate value. However, there is frequently a "fire and forget" attitude, which means that the change in value of share allocations is no longer tracked once the allocation is made. In contrast, the central point of the system we present below is a completely dynamic analysis. This also takes account of the change in value of previously allocated shares in evaluating the overall alignment with long-term corporate value.

A share programme in which a CEO receives a fixed amount in shares (or a fixed number of shares) independent of performance in a specific year does not count as variable remuneration dependent on past performance. The share allocation and therefore the remuneration may be fixed, but the value that can be realised from this share allocation in the future fluctuates. This means that such a plan also creates an incentive effect relating to the changes in the manager's equity position (wealth lever).

These observations lead us to draw the conclusion that neither the board, nor executives, nor the shareholders, nor any other stakeholders can obtain a sufficiently accurate picture of the incentivisation and alignment of management with sustainable company value growth if only annual measures (grant values for LTIPs and paid values for STIPs) are disclosed. A comprehensive evaluation of the variable remuneration requires a multi-year approach and reference to the company strategy. Companies seeking to take the lead in value generation also need to be in the lead in value reporting.



Strategic variable remuneration

Long-term shareholder value as a key metric – without forgetting operational targets

Our proposal assumes that the long-term equity value can be used as an indicator of long-term value added. All information pertaining to value is reflected in the share price (or in the value of equity in the case of unlisted companies[8]) – maybe not immediately, but still within a reasonable period.[9] At the same time, it seems important under a “pay for strategy” approach to remunerate management for achieving strategic and/or operational targets that are in line with the company strategy. In this way, distortions of specific business decisions (or remuneration decisions) possibly caused by longer-lasting, purely market-driven flawed stock market valuations of the business can be mitigated.[10]

Traditional models: RSUs and PSUs

Two traditional and currently popular vehicles for share-based remuneration are Restricted Stock Units (RSUs) and Performance Stock Units (PSUs). RSUs consist of the right to be allocated shares in the future if the employee remains in a continued employment with the company (service condition) over a period of multiple years. The plan posits that when all the information is reflected in the share price (in a timely manner), managers will choose value-increasing strategies and actions. Thus, managers are not incentivised to make specific strategic decisions and actions. From the perspective of the board, this is a hands-off remuneration instrument. (RSUs are sometimes also seen as a tool to foster retention. In practice, this effect is limited; when another company wishes to hire a manager away, they will often just compensate him/her for lapsing prior stock units.)

By contrast, PSUs (also referred to simply as Performance Shares) require, in addition to the service condition, that the manager meets the defined targets over a specific performance period. Only then units may vest and shares will be allocated. The performance criteria often comprise total shareholder return or earnings per share measured over a period of 3-4 years. These are targets that are either very close to the bottom line, or which reflect the actual (shareholders’) equity position.[11] (See the discussion in the call-out box regarding whether targets should be absolute or relative.) While in the case of RSUs, each unit gives the right to be allocated one share at vesting, PSUs have normally an additional lever increasing the factor to 2 or even 2.5 shares per unit if targets are exceeded. Conversely, if minimum targets are not met, zero shares will be allocated. In terms of the payout profile, PSUs turn out to be similar to stock options: In the best case, managers participate disproportionately in the increase of the share price; and as is the case with an option, there is the risk that the manager never receives any payout from their rights if the threshold is not met. The board must undertake a comprehensive critical analysis to decide whether such a leveraged instrument is in line with the company strategy and remuneration policy.

[8] The share price is obviously easy to obtain directly only for listed companies. However, it is possible and useful to calculate the value of equity of unlisted companies in the scope of on ongoing, comprehensive value management process. Of course, in such a case the question of market efficiency arises only in the event of an actual transaction.

[9] There is no scope to enter into a detailed discussion of fundamental questions of market efficiency here.

[10] The extent to which progress towards the strategic and operational targets and expected cash flow is reflected in the market price varies from one company to the next (even if the Swiss stock market, for example, appears to be particularly efficient (in terms of information)). This relates, among other factors, to the transparency of a company’s communications. Active value reporting allows the business to clearly reveal its strategy, identifying relevant drivers of value and reporting with verifiable KPIs on progress in realisation of the strategy. Naturally, in the case of poor performance, managers on the whole have an incentive to be less clear in reporting. It is up to the board to ensure that value is reported consistently. In the long term it pays (including in terms of lower cost of capital) to foster investor trust by means of consistent, reliable (financial) value reporting.

[11] Global Equity Insights 2017, Global Equity Organization (GEO), https://www.equity-insights.org/reports/Global_Equity_Insights_2017.pdf.

The problem of relative performance evaluation

Should performance be evaluated in relative or absolute terms? The simple school of thought is that internal performance should not be assessed in isolation, but in comparison to a suitable reference group or market index. Companies in a similar industry are subject to similar external influences, such as stock market performance or country-specific developments (e.g. exchange rates), which should be filtered out when evaluating performance. This relative performance evaluation (RPE) corresponds to the intuitive understanding which says that managers should not be penalised (or rewarded) for factors outside their control.

However, RPE has fundamental weaknesses. First, there is the risk of opportunistic management behaviour in selecting companies for comparison, or the lack of a robust reference group. Second, for outsiders it is difficult to understand when a manager is paid a high bonus just because their company has done better with performance of -10% than the benchmark companies with performance of -20%, for example. It is not easy to communicate the fact that the system is rewarding the comparably good performance.

Third, the use of a remuneration model in which the level of the variable part results from the ranking within the group can also produce undesired side effects. For example, it may result in a willingness among employees to take excessive risk if the system is calibrated in a way that there is no (or just little) reward to plan participants if the company does not achieve a minimum ranking (e.g., no vesting if the company does not surpass at least the median of the group).

The incentive setting of the model also hits its limits where the individual is able to hedge the impact. Consider an example where the variable remuneration of a bank's CEO is linked to the share price performance compared with an industry index. In economic terms, this corresponds to a long position (buyer position) on the performance of the manager's own bank and a short position (seller position) on the performance of the index. If the CEO goes long on the index, he/she can easily hedge against the risk resulting from the index. The plan rules may forbid such explicit hedging, but it cannot realistically be completely excluded (particularly as the CEO would simply have to buy a sufficient number of correlated products, rather than the index itself, in order to obtain a similar hedge).

RPE, therefore, has its difficulties. It is not only ineffective in some circumstances, but can also be counterproductive. A board needs to weigh the benefits against the risks and side effects before introducing RPE.

STARS

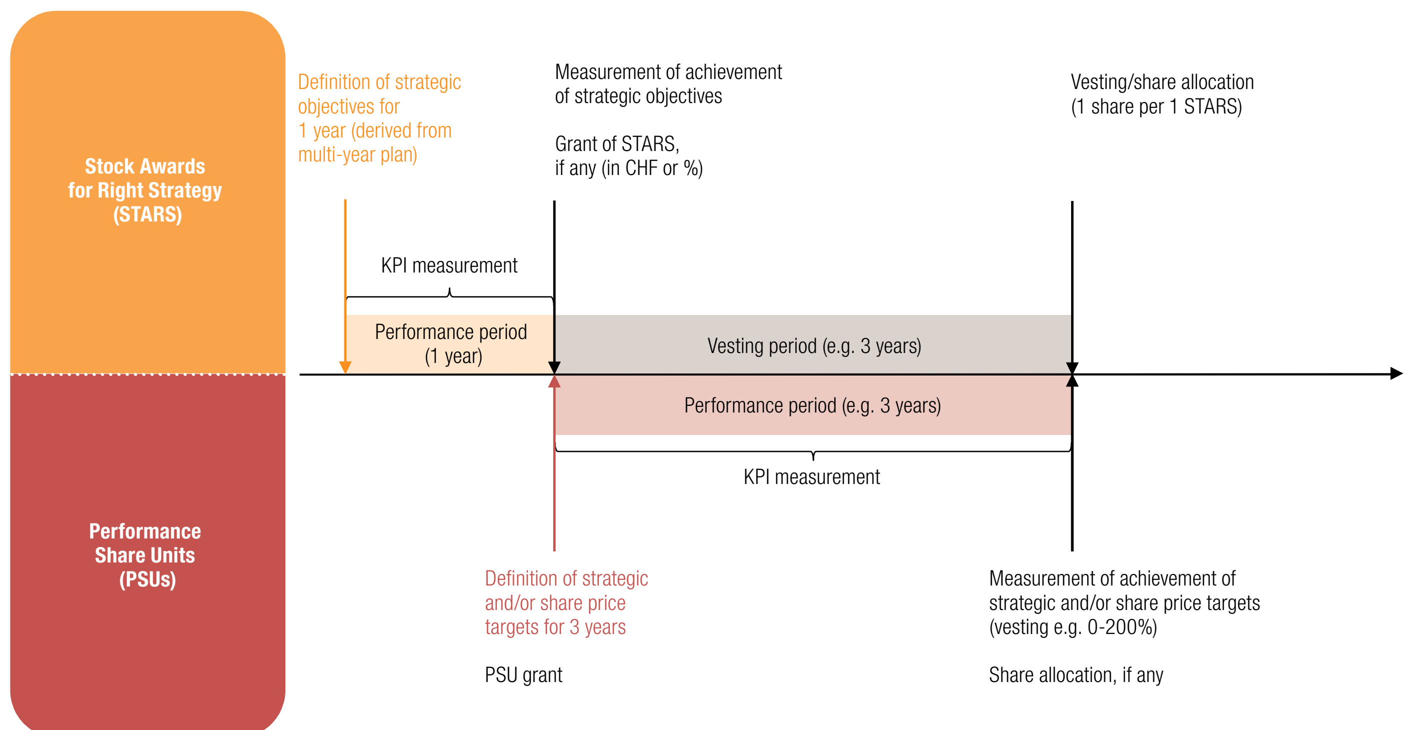
Basic principle

Our **S**tock **A**wards for **R**ight **S**trategy (STARS) proposal uses shares to reward past target achievements that are strategically relevant.[12] Figure 3 illustrates the typical process over time. There is nothing particularly new in giving a bonus in the form of shares. However, the key points about the system presented here are, first, the specific alignment of remuneration targets with the company's strategic objectives and, second, the consideration of the changes of the manager's equity over time (wealth lever). These two points are discussed in detail below.

The board runs the ship

STARS are a hands-on instrument for the board. They put the board's role of leading the company into the future in the spotlight.[13] The strategic objectives that underpin STARS must be tailored to the company's specific business model. The specific set of performance indicators that best documents the achievement of strategic (interim) objectives must depend on the company's individual situation. STARS do not dictate best practice for the targets. For example, a board may come to the conclusion that digitalisation is a key topic for the company. This could result in corresponding, specific one-year targets being defined. Ultimately, this aspect will also feed into cash flow and then into the share price. However, a board must be able to specify a clear strategic vision of the company with corresponding strategic objectives, even if these are not rewarded by the stock market in the short or even medium term. This requires a (sometimes tricky) balancing act: The board and the management must not remove themselves completely from the needs of the shareholders. Nevertheless, it seems to us essential, especially in view of the increasingly short-term perspective of the financial markets, that courageous boards pursue the strategic objectives for their companies and underpin as well as reinforce these with suitable remuneration systems.

Figure 3: Contrasting STARS and PSUs



[12] Whether achieving a target of X% in a specific year results in a multiple of a number of shares or a multiple of a specific amount in shares is generally a matter of taste. A disadvantage of defining the amount in CHF is that if the share price happens to be low, a higher number of STARS will be granted and a higher number of shares may vest.

[13] We are here discussing this incentive system in the Swiss context, where the board plays an important role in setting the direction of the company. In two-tier systems like Germany, where the board plays mostly a supervisory role, it would be the executive board which would take on some of these tasks.

Dynamic disclosure drives dynamic decisions

When STARS are used consistently over time, managers may build up substantial share positions over the years. Owing to the wealth impact on the managers' shares (or shares to be allocated in the future), the management perceives changes in business development in terms of the change in the equity value of the company. Especially when managers hold substantial share positions, these value fluctuations can be significant. It is, therefore, essential that these changes in equity value are also reflected in the remuneration discussion.[14] Alongside the resulting signalling effect to the outside world, there is also a need to communicate the wealth impact internally. It is common to provide employees with an annual overview of their overall remuneration. However, generally in practice today the change in the value of equity-based compensation is not taken into account or discussed. Such a complete overview would, however, be useful both for the managers as well as for the board and remuneration committee.[15]

Share ownership guidelines

Figure 3 suggests that STARS are earned over a period of 3 years (for example) after grant. This means that the share allocation occurs only at the end of the (vesting) period in the case of an active employment relationship. This makes sense in view of the desired long-term orientation of the managers. However, it is also possible to allocate blocked or unblocked shares immediately to the management as long as they are required to build up and hold a defined number or defined value in shares of their own company. Such requirements (known as share ownership guidelines) are today increasingly common among large companies. They are less widespread among medium-sized businesses and still very rare for small ones (see Insights 2018 parts 1 and 2).

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[14] A similar proposal is made in The Purposeful Company, Executive Remuneration Report, February 2017, Big Innovation Centre, http://biginnovationcentre.com/media/uploads/pdf/TPC_ExecutiveRemunerationReport_26Feb.pdf. In particular, see p. 45: "Disclosure regulations should, therefore, be reformed, better to show the link between pay and performance, taking account of previously granted equity. To effect this, as well as disclosing the single figure of pay, the company should show the wealth impact: the pre-tax change in value over the reporting year of previously granted vested and unvested equity awards. The absolute £ value of the total shareholder return over the year should also be disclosed. These items should be disclosed for the last ten years alongside the current requirement to disclose the single figure and vesting history."

[15] Following previous good performance, a manager has more "skin in the game". Where the manager previously received more, a drop in operational performance subsequently results not only in lower "flow" compensation, but also in greater loss in wealth. A board must therefore also keep an eye on any undesirable risk incentives that may arise once managers perceive themselves to be in the loss domain.

Conclusions

Simplicity is a virtue for compensation systems. Managers prefer simpler incentive systems; by contrast, they heavily discount the value of complex systems. At the same time, incentive systems should explicitly incorporate the often neglected dynamic component in disclosure and discussion of outcomes. The STARS model presented in this part 3 of Insights 2018 achieves both of these aims.

We have analysed the system in isolation from possible influencing factors in specific situations. In concluding, we mention a few of these. First, there are situations in which an excessive focus on equity is not suitable. Highly indebted companies may do well to use “inside debt”, i.e. to incentivise managers to take account of the position of creditors directly (and not only indirectly via the value of equity).[16] Second, regulatory frameworks can also limit the design opportunities, which is particularly applicable in the case of financial-sector companies. Third, this article sets aside tax-law aspects.[17] Despite these limitations, it is useful to consider the “blue-sky system” to understand the extent to which a current given system deviates from it and whether this is desirable.

A rational and long-term focused remuneration system is a necessary, rather than a sufficient condition for value-generating corporate governance. The board and executives together must take a holistic view that tightly links the design of the remuneration system, the composition of the board and the executive, shareholder engagement, and value reporting.

[16] Cf. Edmans, A./Qi, L. (2011), Inside Debt, Review of Finance 15, 75-102 and Chesney, M./Stromberg, J./Wagner, A. (2018), Managerial Incentives to take Asset Risk, Swiss Finance Institute Research Paper, which discuss the incentive impact of stocks in highly indebted companies.

[17] In Switzerland tax is levied at the time of the actual share allocation. If the shares are subject to a sales restriction, a tax deduction on the share value can be obtained.

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