

## The Changing Face of Remuneration in Tough Economic Times – What should you be doing?

In the wake of the global financial crisis, excessive pay and bonuses have caused a furore. There has been significant denunciation from governments, regulators, industry bodies, stakeholders and the general public on the extent of 'pay for failure' which has been exposed.

The response has been just as dramatic as the leading stock markets' response to the failure of so many financial institutions. Accusations have been levelled, indignation aired and now it appears it's time for the 'big stick' to come out and be brandished about.

Those in for the biggest (metaphorical) beating are those in the finance sector, and/or those in receipt of government bail out packages (such as the US based TARP scheme). Governments and regulators worldwide are criticising and taking a prescriptive approach to executive remuneration.

The list of flaws in past practice, prohibitions for future practice and advice offered with a 'comply or explain' tone is exhaustive. So, if you're lucky enough to not be working in the beleaguered finance sector right now (where your path is being laid out for you), you may well be asking yourself two things:

1. To what extent does this affect me?
2. What action should I be taking?

First things first. To what extent will this affect you.....?

Even if you're outside the finance sector, the ramifications of executive compensation and incentive reform are likely to affect you materially. While legislative reform is currently focused on financial institutions (and those in receipt of bail out funds), in our view the whole remuneration landscape has now changed, possibly permanently. The change may touch those directly in the reformer's gaze first, but the long term impact will touch all.

Why? Flawed incentive designs have been identified as a significant causal factor in the finance sector collapse and subsequent recession. Hand-in-hand with this is the questionable decision-making by many businesses on executive remuneration. In a field of failure, money was paid out hand over fist to executives by way of highly leveraged bonuses, stock, stock options and golden handshakes. 'Pay for failure' has been called out, scrutinised, criticised and publicised. It's unlikely this will fall off the media radar any time soon. Therefore, Boards of Directors will have to assume that stakeholders, shareholders and consumers will be calling them to account on this front with a new vigour and improved understanding. With increased awareness and scrutiny, the bar will no doubt be raised for rational, defensible, sustainable remuneration practice, not only for Executive remuneration, but at all levels.

*So, what action should you be taking?*

The good news is that not everyone needs to prepare themselves for a frequent and exhaustive review of their remuneration practice by a bevy of regulators. Nor will some of the remuneration and incentive guidelines being levelled at the finance sector be appropriate for all industries. Nonetheless, to ensure your practice is rational, defensible, sustainable (and unworthy of attack on the front page of the national newspaper) – you'd be well placed to apply some of the more common sense principles emerging as part of this legislative and regulatory overhaul.

The checklist below provides a robust '**Warrant of Fitness**' assessment. The more boxes you can check, the better placed you'll be to defend the remuneration practice and decision-making in your business:

### **Remuneration Policy**

- You should have a well articulated remuneration policy. This should cover the key principles of your remuneration decision making and intent
- The policy should be readily available to staff, establishing a blueprint for the basis on which they will be rewarded
- Your remuneration policy should be consistent with your overall risk philosophy
- This policy should be visible to your shareholders – to the extent where it does more than simply meet the old disclosure requirements

### **Incentive Schemes**

- Incentive schemes need to be aligned with long-term, prudent financial planning. Short term schemes which focus on short term profit drivers to the detriment of long term financial viability should be reviewed or terminated
- Incentive pay should be directly tied to the health of your organisation. All non-sales incentive pay should be influenced by the financial performance of the whole business
- Incentives should be based on a combination of individual and collective performance. Risk is created where individuals can still receive large incentive payments based on their performance, even when the organisation collectively has under-performed
- There should be a sensible relationship between base salary and variable pay. The most appropriate balance depends on the specific role, but bear in mind that highly leveraged schemes or uncapped schemes will be under more scrutiny than previously
- Where a significant bonus is paid, best practice is to include some deferred component. In this way the relationship between the risk horizon and the reward horizon can be strengthened.
- Variable Pay should either dramatically lessen or disappear when organisational performance materially worsens
- Employees should not have to rely on bonuses. In every instance, an organisation should feel that they have the flexibility to not pay bonuses/incentives based on financial considerations

### **Executive Remuneration**

- Executive remuneration should be decided on by the Board, or the remuneration subcommittee of the Board
- Board members advising on remuneration should be well versed in the field, and a majority of independent directors should make up your quorum
- A Firm's Board of Directors must actively oversee the remuneration system design and operation – particularly at executive level and where highly leveraged incentives are in place
- The mix of cash, stock and any other forms of remuneration must be consistent with risk alignment. The business should always be in a position to explain the rationale for the mix.

Some argue that governments and regulators have over-reacted to the crisis and are now being so prescriptive on remuneration that they are interfering with organisations' genuine flexibility to manage their business. For now, until more time has gone by, and the impacts can be assessed over the longer term, the jury remains out on that one.

However, some things are for certain. The crisis has brought remuneration practice under the spotlight, and media and other watchdogs have a strong appetite to keep this contention front of mind for all. On that basis, a little scrutiny of your current practice and applying some of the collective key learnings from the crisis would seem to be a sure bet.