

Recession-driven change to yield a new era for Executive Compensation

As the impact of last year's finance sector collapse wreaks its havoc on world economies, governments across the globe are getting on with proposing and passing a range of legislation to tackle the role that executive remuneration practice has played in the debacle.

The common thread emerging as the catalyst for the proposed changes appears to be a fundamental lack of common sense by many businesses in their remuneration practice for executives. This has played out across the spectrum of Base Salary, bonuses, incentive scheme design (including shares and share options) and termination payments (aka Golden Parachutes).

This lack of common sense was so perfectly demonstrated a few weeks ago, when the beleaguered Citigroup, just recently in receipt of a US\$45 billion tax payer funded rescue package, were outed on their imminent purchase of a US\$50 million 12 seater luxury private jet! Newly inaugurated US president Barack Obama put the kibosh on that one – but such intervention into the corporate spend and remuneration management decision making of ailing businesses will just be one in a long line.

There is a wave of legislation emerging from the United States and Europe to address more responsible decision making on executive compensation. The wave is two-fold.

Firstly, specific criteria and commitments which must be met by companies in receipt of bail-out packages. These demands have a short timeframe for turnaround and compliance. The second wave is 'across the board' improvements to corporate governance practice and principles. Specifically targeted is board and executive decision making on compensation matters.

A substantially increased accountability for the Board of Directors for Executive Remuneration practice is the common denominator amongst both these waves of projected and confirmed legislative change. If demonstration of common sense can't be relied upon, it appears it will be legislated.

So what are the trends that are emerging from this flurry of activity? Some of the common ones are as follows:

- Remuneration policies must be fully explained and justified, especially where any change (read increase) is proposed
- Incentives must be re-aligned to avoid excessive risk taking (in particular, organisations must have in place clear incentives which work to promote stability and to balance short and long term business performance). *NB The extreme concentration on short term objectives to the detriment of long term performance and sustainability has been highlighted by many as a significant contributor to the finance sector collapse*
- The requirement for maximum ratios between fixed and variable pay to be introduced
- The requirement for remuneration ceilings for executives in underperforming companies to be introduced
- Improved transparency of compensation components (in some countries even disclosing up to the individual level) to give shareholders/remuneration committees more information on which to act. This transparency is to extend to retirement and change of control clauses
- The requirement for the improved transparency of all compensation items for directors, (including valuation of awarded share options, whether potential or vested)
- Where a company has underperformed (and the share price has dropped significantly), mandates for the level of rewards (particularly in share incentive schemes) to be revised, downwards

- Restrictions on Golden Parachute payments – specifically recommended limits for ‘leaving pay’ of no more than 12 – 18 months’ salary
- The cessation of any additional remuneration payments in relation to succession or retention, particularly if such payments are not linked to performance conditions
- Prohibition of any ‘artificial’ increase in remuneration during the period preceding the termination of an executive
- Increased rates of taxation or removal of tax exemptions for share option plan income
- Increases in the required number of independent directors on the remuneration committee.

These are just the highlights; the full list is a long one.

Also tabled in the UK, is a requirement for quoted companies to report on how the pay and employment conditions of employees were taken into account when determining directors’ pay.

Austria has gone even further in its review, stipulating that in certain situations, companies in the finance sector may be compelled to recall payments already made to executives, if they are deemed to have been harmful or inappropriate in the wider context of the institution’s downfall.

So what do we, down here in New Zealand, need to take from this? Change is coming, and coming fast. Executive and Director Remuneration will be under the spotlight like never before. The eternal scout’s motto would seem to be most appropriate, “Be prepared”. Get your houses in order.