

COMPENSATION

Developing an effective executive compensation strategy

BY MARK WILLIAMS



Shareholders and the market in general are increasingly sensitive to how much public companies are paying their top executives. They are pushing for greater transparency and disclosure on how and why compensation packages have been created. In response to widespread concerns, companies are striving to be objective when assessing executive pay. They are more inclined to set performance targets and drive accountability among executives. But at the same time, companies need to devise competitive packages that attract or retain executives who have the ability to navigate a difficult economic environment. Boards therefore need to develop sophisticated reward structures that satisfy both sides.

Macroeconomic conditions and regulatory developments have combined to put executive compensation back in the spotlight. “The recession, coupled with new proxy disclosure rules in the US and Canada and large payouts to departing executives of major banks and Wall Street firms, has resulted in significant scrutiny and criticism of executive pay by the media, the public and some members of the US Congress. Boards have become more sensitive to the investor and public relations ramifications of their pay decisions,” says David Swinford, president and chief executive of Pearl Meyer & Part-

ners. He adds companies are now paying particular attention to severance benefits, change in control benefits, perquisites and the relationship of pay to performance.

One of the legacies of past corporate governance failures is today’s heightened regulatory regime. In the US, the Securities and Exchange Commission has taken steps to open up public companies by making them more transparent about their goals and measures. In 2006, the regulator introduced proxy disclosure reforms and hit back when companies cited concerns that releasing such information would put them at a competitive disadvantage. Companies also argued that it was difficult to explain the reasons behind their compensation decisions in simple terms, which is reflected in proxy statements that are not reader-friendly. The SEC has since taken feedback on board and responded with a set of revised Compliance & Disclosure Interpretations in July 2008. These guidelines provided clarification regarding the disclosure of targets and benchmarking practices, and eliminated the need to disclose ‘immaterial’ goals and to explain the reasoning behind the evaluation of executives’ personal performance.

Since regulations ensure that public companies, at least on some level, are transparent about the reward arrangements they have in

place for their executives, it is important to manage the way these plans are interpreted. “On occasion disclosure can cause problems in terms of the perception of the value of an executive’s overall package,” says Justin Rix, a director at Grant Thornton. “It will generally be valued at the best case value from the executive’s perspective. But if poorly designed, plans might include payouts when performance is perceived to be poor. A company that has a well designed executive reward program, however, can use this to demonstrate to existing and potential investors that it is a well managed business with a clear strategy.”

Institutional investors are widely thought to be the major catalyst for change, although this is not entirely accurate. They are certainly taking a closer look at executive compensation, but when doing so they are heavily influenced by external advisers, which makes them a conduit rather than a driving force. Most fund managers do not have time to analyse every forthcoming proxy vote, so they often rely on the recommendations of specialist companies such as RiskMetrics in the US. In the UK, a set of regularly updated guidelines are published by the Association of British Insurers, outlining best practice for executive remuneration arrangements. Institutional investors often insist that companies adhere to these guidelines.

Decisions are in effect delegated to these external agents, which tend to have a clear, predefined notion of how shareholders should respond to certain compensation issues. Because many fund managers follow their lead, proxy advisers have considerable weight when it comes to influencing board decisions. But the trouble with preset guidelines and centralised advisory firms is that they present boards with relatively inflexible suggestions without accounting for the unique requirements of each public company. Although they form the basis for a solid framework, experts believe they may be too formulaic. When the majority of shareholders put forward similar demands and expectations, there is limited scope to design

a compensation package that is tailored to a firm's particular strategy or style.

The corporate response: enhancing reward structures

Although compensation packages are under more scrutiny, companies cannot reduce pay arbitrarily to appease unhappy shareholders. Now more than ever, companies need to lure talented individuals to guide them through the economic downturn. Executives need to be adept at driving performance, cutting costs, reorganising businesses and improving operational efficiency. Companies that fail to offer compelling reward structures may see leading candidates head to their competitors. "Many if not all companies are cautious in light of the current economic uncertainty and concerned as to how this may impact their business," says Mr Rix. "As a result, boardrooms are focusing on the need to ensure that they have effective and competitive executive compensation strategies in place to attract and retain the top talent and make sure that they are best positioned to see them through any difficult times ahead." He adds that the executives not only need to make tough decisions to weather the storm, but also react to opportunities when they arise by taking calculated risks.

So reviewing compensation structures does not necessarily mean reducing them. It means assessing their strengths and weaknesses and making changes to ensure they are appropriate for current market conditions. Indeed, the compensation for chief executives of S&P 500 companies actually rose by almost 16 percent in 2007, according to a study released by research firm The Corporate Library, despite an overall slowdown in the rate of increase among all companies studied. But some observers fear that boards are too close to their chief executives and too easily swayed. A chief executive's lengthy explanation about why targets were missed due to the market downturn may be enough to convince a board to pay out a bonus regardless. To appeal to shareholders, compensation committees need to make disciplined judgements when devising compensation packages. They should also maintain objectivity when making regular assessments about whether changes are necessary down the line.

A sound reward structure should balance labour market competitiveness, short term business objectives and long term shareholder gains, according to Mr Swinford. "Everyone, including executives and shareholders, should expect to make less money in difficult economic times and more money in good times. It is as inappropriate for executives to expect to be completely protected from the impact of a recession as it is for shareholders to grouse about how much money executives make in an up-market," he says. He adds that executives will be fairly rewarded if the company offers a competitive base salary, pays an executive for accomplishing key objectives in the short term and ties the long term portion of the package to shareholder returns. Even when there are some short term anomalies, such as unusual market situations, the pay will remain fair. This helps a company to hold on to key personnel in difficult times, when job security may be at its lowest and head hunters are trying to tempt talented individuals away.

Executive rewards should be linked to the strategic objectives of the business, so an executive's actions when pursuing his or her incentives take the company in the right direction. They should also be based on performance, and bestowed in greater proportion than for other employees of the company. But perhaps the most important consideration, in light of recent concerns about executive compensation, is to demonstrate a connection between the pay package and shareholder value. One way to do this is by tying compensation to the company's share price, either by measuring the company's performance as reflected in earnings per share or by using the performance of competitors as a benchmark for success.

Equity compensation is taking up a larger portion of total pay packages so that executive benefits are tied to shareholder gains and losses. "The critical issue here is over what time frame executive compensation must be shown to positively impact shareholder returns," observes Mr Swinford. "One year is clearly too short a timeframe. The right period is more likely five to 10 years, depending upon the industry's business and investment cycles. Many, in fact most, shareholders do not stay invested in one particular company

that long," he adds.

It is important to set appropriate targets that are challenging but achievable. Performance indicators should draw on external information sources that analyse how competitors are performing and also take into account the company's historical performance. Other areas of analysis include the cost of equity and debt as a measure of economic value. Once the compensation committee has studied these measures and set reasonable targets, the next step is to communicate them clearly so that expectations are aligned between the board and executives.

But the process is not all about the employee. The company should also give thought to how it will benefit from any compensation structure. "It is also important for a company to ensure that they are maximising the value of their reward programs, to get the most bang for their buck. For example, the introduction of flexible benefit arrangements to increase effectiveness of employee benefit programs, continual review of incentive plans to ensure that cash is being put in the right peoples' pockets, effective communication to employees of the overall value of their reward package, and so on," says Mr Rix. "The cost efficiency of delivering employee reward should also be considered. This is in respect of both the costs of the reward itself and the associated administrative processes required to deliver it," he adds. Employee share plans can be an attractive option during tough economic times as they are based on a recovery of the company's share price once economic conditions improve.

Beyond a more effective compensation strategy, companies can take a fresh look at their overall hiring process. Experts suggest recruitment and selection processes could be better. The focus needs to be on using key metrics to hire the right type of executive in the first place. If the wrong person is brought on board in a senior role, disastrous decisions could follow – particularly with the added pressure of widespread economic uncertainty. "The costs of catastrophic errors made in the selection of chief executives have been mind-numbing," says Mr Rix. "These go beyond the cost of the 'golden parachute' and the misdirected bonus payment, to the fundamentals of the loss of profit and revenue, the loss of market share

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and the loss of value in the share price. For executives operating in extremely fast-changing environments, many are being recruited for roles which have not even been experienced by anyone previously in the organisation. Thus the roles faced by the fresh recruits are new, perhaps sailing in uncharted waters, often in a fast growing or fast changing environment, where past competencies are less important than the capacity to learn fast, think quickly on one's feet, and adapt to contingencies rapidly and without catastrophic errors." With modern methods of talent identification, these capacities can be explored in depth, accurately and reliably, so the recruits best suited to development for these roles can be readily

spotted and nurtured.

Companies need to decide whether an executive candidate is up to the task of successfully executing their job now and wherever it may lead them in the future. As part of this process, they should spend time analysing the candidate's behaviour in depth. Companies are already beginning to focus more on the individual's personal style and demeanour, according to Mr Swinford. "The candidates' behaviour in discussions with the board and potential future subordinates or peers is an important indicator of how the individual will act once in place," he says. "The search firm helping the board should be encouraged to assess style, communications capabilities, openness

to others' ideas and the like in the screening process." He points out that it is also worth speaking to the candidate's past colleagues and other business contacts to gain further insight into these qualities.

Compensation committees are now making their decisions under the burden of greater responsibility and intense external scrutiny. Satisfying shareholders, regulators, the media and the public, while keeping executives incentivised, requires a delicate balance act. Companies need to put more thought into their pay strategies and recruitment programs to stay ahead of the competition, or risk falling behind companies that can get the formula right. ■



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Mr. Swinford previously served as Senior Managing Director and head of Pearl Meyer & Partners' New York office. Prior to joining the firm, Mr. Swinford was a Principal and Worldwide Partner of William M. Mercer, Incorporated, where he was National Practice Leader for executive compensation. Mr. Swinford also has served as a Vice President at Towers Perrin, with worldwide responsibility for the executive compensation consulting practice, and in positions at Sibson & Company and Harris

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