

# **Recommendations on Executive Remuneration**

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### **Responsibilities and powers**

1. Responsibility for the remuneration of the Executive Board lies with the Supervisory Board. The Supervisory Board sets up a remuneration committee consisting of independent members. The committee draws up a remuneration policy which complies with the recommendations stated below.
2. The Supervisory Board is responsible, and can be addressed through the General Meeting of Shareholders, for all aspects of executive remuneration. The Supervisory Board accounts for its activity in this area in the annual report.
3. The approval of the General Meeting of Shareholders is necessary for share and option schemes, but not for their specific implementation on an individual level. The latter remains a task for the remuneration committee.

### **Reasonableness and effectiveness**

4. The overall remuneration package must be tested for reasonableness and effectiveness. With regard to the level of remuneration, the Supervisory Board must form an independent judgment and not only assess it on the basis of market comparisons or historical precedents.
5. The link between the remuneration policy and the company's long-term strategic objectives must be explicitly defined and must be testable.

A substantial part of the overall remuneration package must be linked directly to predetermined performance objectives; the executive remuneration must also be largely of a long-term nature.

6. The remuneration system must take account of the prevailing social standards and values. This will prevent outcomes which could be seen as excessive. A good remuneration system provides the right incentives but does not unintentionally encourage behaviour which conflicts with the interests of the company or leads to the reporting rules or other legal provisions being applied in a way which is not in accordance with their material purpose.
7. The remuneration committee must periodically ascertain whether the chosen instruments have actually contributed to the achievement of the strategic objectives.

### **Use of remuneration instruments**

8. The use of remuneration instruments is a function of the chosen mix of fixed and variable and short- and long-term remuneration instruments.
9. The choice of specific instruments must be made on the basis of effectiveness; reporting practice or fiscal possibilities are secondary factors.
10. Option and/or share schemes can be part of the long-term, variable part of the overall remuneration package.  
These schemes must meet a number of requirements:
  - long-term nature
  - realisation over time; preferably at predetermined times over a period of many years
  - linkage to the company's strategic objectives can be achieved by:
    - making the number of options or shares to be issued dependent on the achievement of preset targets, or
    - issuing 'customised' options or shares whereby only the relative performance of the share compared to a previously agreed benchmark is remunerated.
  - repricing of options is not acceptable.
11. The combination of high variable remuneration and favourable exit schemes is not acceptable; a favourable exit scheme detracts from the incentive which should result from a variable remuneration structure.
12. The company should as a rule not grant loans to executives.

### **Reporting**

13. All aspects of executive remuneration, including the policy, objectives and results, must be reported on transparently, fully and consistently in the annual report.

In the case of options or shares, details must be given on holding periods and sale times.

Directors must report the realisation of options and the sale of shares at the time of realisation or sale.

14. The economic value of options at the time they are granted must be stated as an expense in the company's profit-and-loss account.

## Notes to the Recommendations

### 1. Carrot or stick?

The current structure of public companies is characterised by a separation between the company management and the shareholders. It is managers' capitalism and not owners' capitalism. In this model, the emphasis is on the company management: it is they who determine and implement the strategy. The Supervisory Board only has a supervisory role and the shareholder can at best consent to it.

In order to ensure that the interests of shareholders and executives nevertheless run in parallel in this model, the remuneration instrument has been selected. The remuneration package has built-in incentives which are intended to make managers' capitalism more shareholder-friendly. In other words, the carrot<sup>1</sup> has been chosen. The question is then whether the chosen system also works well in practice. This depends on its design and actual implementation, for which clear and measurable objectives must first be specified.

### 2. Clarity of objective

In a system based on maximising shareholder value, the objective appears to be clear: to maximise the market value of the company. But in practice it is not that simple. Maximising the market value turns out to be a largely unsustainable process, particularly when it is driven by easily manipulated figures such as pro forma earnings per share.

The great emphasis on short-term market value makes the company prey to the volatility of the stock market. This is illustrated by the following quotation from The Economist of 16 November 2002.

#### **Drugs in the boardroom**

*Mr. Jensen<sup>2</sup> now thinks that the way in which executive pay was typically tied to share performance through options meant that, in the bubble, the carrots became what he calls 'managerial heroin', encouraging a focus on short-term highs with destructive long-term consequences. Once a firm's shares became overvalued, it was in managers' interests to keep them that way, or to encourage even more overvaluation, in the hope of cashing out before the bubble burst. Doing this not only meant being less than honest with shareholders, or being creatively optimistic with corporate accounts. It also encouraged behaviour that actually reduced the value of some firms to their shareholders-such as making an acquisition or spending a fortune on an Internet venture simply to satisfy the whims of an irrational market.*

<sup>1</sup> It is also possible to opt for the stick by combining high basic pay with a simple dismissal mechanism. Shareholders will not readily do this unless the continuity of the company is guaranteed. Gilt-edged exit schemes are nevertheless completely out of the question. Dismissal must be a disincentive.

<sup>2</sup> Michael Jensen was a senior lecturer at Harvard Business School, and in the 1970s was the great advocate of option-based remuneration for executives as a solution to the principal-agency conflict in the modern company.

But what are the alternatives?

We can identify three:

- Long-term profit growth
- Long-term profit growth translated into an operational performance contract
- Long-term price growth against a previously defined benchmark.

Long-term profit growth looks like an attractive alternative at first sight, but the drawback is that the notion of profit can be manipulated and is therefore, in an amplified form, the derivative of profit: profit growth. Moreover, the notion of profit used in accounting makes no allowance for other factors that determine the value of the company, such as changes to the risk profile, the levelling off of forecast profit growth and, last but not least, the quality and reputation of the company. That makes achieved long-term profit growth unsuitable for use as the sole objective variable.

The second alternative is based on long-term profit growth as a primary objective of the company, but translates this primary objective into measurable instrumental objectives. Executive remuneration is linked to performance measured against these instrumental objectives.

This model, in which the remuneration is linked to an explicit performance contract which in turn is derived from the strategic corporate objective, is very appealing. However, it requires the Supervisory Board to become involved in the operational activities of the company in a way which is often unworkable in practice.

The third alternative accepts the information asymmetry between the management and the supervisors as a fact. By linking remuneration to the long-term trend in the share price, set against an appropriate benchmark, alignment of interests can easily be achieved between the agent (= company management) and the principal (= shareholder). This model too has problems of measurability. In particular, the choice of benchmark is susceptible to manipulation. M. Jensen recommends opting for a cost-of-capital benchmark; others prefer a peer-group index. The advantage of a peer-group approach is that it affords protection against the high absolute volatility of the stock market and focuses more on the specific factors which determine the value of the company. It is left to the market to discount all the factors that are of relevance for the value of the company. In this regard it can therefore be described as an objective system.

The conclusion is perhaps that an explicit performance contract with measurable instrumental targets derived from the company's strategic objective is preferable, but in many cases is aiming too high. That applies in particular in situations in which the Supervisory Board operates at a relatively large distance. In such situations, a direct link to the share price is a good second choice, provided its long-term nature is guaranteed and the price trend is set against a relevant benchmark.

### **3. The design of the remuneration policy**

The remuneration policy must be assessed from two perspectives:

- Is it sufficiently attractive to high-calibre executives and of a reasonable level having regard to the delivered performance?
- Does the policy produce the right incentives to achieve the company's strategic objective? In other words, is it reasonable having regard to the specific labour-market situation and fair having regard to the social standards, and finally is it effective?

The question concerning reasonableness and fairness relates chiefly to the level of the remuneration, in relation to the delivered performance and the specific market environment in which the company operates. The Supervisory Board must form an independent judgment on these aspects and cannot simply hide behind benchmarking studies by external consultants. Furthermore, the company must expressly state with which reference group it is comparing itself when setting the level of executive remuneration.

The question of effectiveness relates chiefly to the design of the remuneration package. The relevant factors are the mix of fixed and variable and short- and long-term remuneration components. In market-oriented companies, in which the Executive Board has primarily to demonstrate entrepreneurship, a suitable remuneration mix is one which puts the emphasis on variable and long-term remuneration components. In companies focusing on operational efficiency, capital efficiency and managed growth, the emphasis can be on fixed remuneration elements. In the Netherlands, the balance between fixed and variable has traditionally been in favour of fixed; greater emphasis on variable and long-term elements would benefit the effectiveness of the remuneration policy.

Variable remuneration instruments are cash bonuses, options and shares. The cash bonus is mainly a short-term instrument; options and shares are suitable instruments for the variable, long-term component. Options have recently acquired a bad name. This has more to do with defective design (short-term, hidden costs, link to absolute share performance, etc.) than with the benefits of the instrument itself. Options should be used as a long-term instrument, preferably in the form of overlapping schemes with fixed exercise times spread over many years. The repricing of previous option packages is out of the question. The incentive character of options would be negated if repricing were to become standard practice. The granting of shares must also be of a long-term nature, with pre-defined minimum holding periods. In all cases, the costs of these schemes must be carried in the profit-and-loss account.

Long-term remuneration can also be of a fixed nature, for example through pension schemes and other fringe benefits. Because of their long-term nature, they are loyalty-enhancing and should be explicitly included in the assessment of the overall level of the remuneration package. Their costs must be clearly visible. As a rule, long-term loyalty instruments such as the granting of loans should not be used.

Exit schemes and change-of-control provisions should be assessed primarily from the perspective of effectiveness. Covering the risk of non-performance appears to provide a good stimulus to achieve a maximum result. As a general rule, effectiveness should prevail over cost-efficiency when setting executive remuneration.

#### 4. Should share and option schemes be approved by the General Meeting of Shareholders?

Until a few years ago, executive remuneration was not a major subject of discussion. In the United States, options were seen as an important instrument for creating alignment of interests between the management and the shareholders. In Europe, the attitude was generally somewhat more reserved, but here too this view gradually gained ground. Objections were raised – chiefly in Europe – when the bull market of the last few years caused remuneration to rise exponentially. In particular, the scandals at Enron and elsewhere have convinced many people that an efficient remuneration system must be accompanied by effective safeguards. The list below shows that whereas up to 2000 remuneration policy was seen as a responsibility of the non-executives and supervisory directors, since then the general trend has been towards promoting approval by the General Meeting of Shareholders to provide an additional safeguard.

1. Peters (1997)	Remuneration a task for Supervisory Board (recommendation 15 <i>et al.</i> )
2. OECD Principles of CG (1999)	Remuneration a task for non-executives (point V.D.2)
3. ICGN Statement on Global CG Principles (1999)	ICGN appears to concur (Statement 5 and amplification of OECD point V.E.1)
4. SCGOP manual (2001)	Option schemes to be approved by shareholders' meeting (Benchmark 14)
5. Final Winter Report (2002)	Executive option schemes to be approved by shareholders' meeting (p. 66)
6. Hoogervorst, Fortis Lecture (2002)	Bill in preparation: approval by shareholders' meeting of executive remuneration in shares and options (p. 8)
7. ICGN Report on Executive Remuneration (2002)	Remuneration a task for Remuneration Committee (point 9), but approval by shareholders' meeting is desirable and necessary (point 55)

In the Netherlands, companies such as Unilever, ReedElsevier and Philips now present their option and share schemes for approval by the General Meeting of Shareholders.

It is fair to say that seeking approval of the General Meeting of Shareholders for instruments of flexible remuneration is increasingly seen as best practice. The question is why. In this connection it is important to consider the arguments for and against such a requirement. The main arguments are as follows.

Arguments in favour of requirement of shareholder approval:

- Quite often costs are involved which could have a substantial impact on shareholder value.
- The requirement helps to reduce agency effects, by forcing executives to focus their incentive structure more on the interests of shareholders.
- In many cases the transparency of remuneration is still very poor. The requirement of shareholder approval can serve as an additional means of improving transparency. After all, shareholders can withhold their approval if they are not satisfied.
- The disciplinary effect of the approval requirement can further help to prevent abuse and excesses.

Arguments against:

- Shareholders can become inclined to concern themselves with (individual) remuneration at a detailed level.
- Detracts from the company's flexibility and competitive strength in the "market" for captains of industry.
- Shareholders could abuse the right in order to achieve other aims, even though – were that to happen – the problems would probably then be far greater.

Shareholder approval can take many forms. In general, shareholders' involvement in (individual) remuneration at the detailed level is undesirable. They must limit themselves to setting the framework and monitoring the main points. In this connection, the recommendation of the Winter Committee is constructive: approval by the General Meeting of Shareholders is necessary for share and option schemes in themselves, but not for their specific implementation on an individual level. The latter remains a task for the remuneration committee.

The Winter Committee's recommendation creates a bridge between the responsibility of the company and the interests of shareholders in a way which accords with general best-practice standards. It would seem sensible to seek to apply these findings also in the Netherlands.