



**Executive Compensation**  
The way ahead for equity within the package




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**Agenda**

1. Some theory and some history
2. The rise of the mighty option
3. Equity diversification
4. The role of regulation and the law of unintended consequences
5. How corporate equity fits within the wider pay practices elsewhere – and what about pensions
6. The impact of globalisation and IT
7. Some predictions for the future
8. Is incentive pay immoral?

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**Agency theory**

- Executive pay goes up as company size gets bigger. If pay is not performance linked, the incentive is to acquire even if shareholder value is destroyed
- This is an agency problem – addressed in part by performance pay
- Part of the performance pay concept is alignment of interest with shareholders
- So why not pay in equity? In particular options are good
  - In fact the more performance pay the more alignment – surely
  - But options don't align with shareholder interest and self interest reasserts itself for executives – bringing back the agency problem!

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### Alignment: Reward Strategies

Why do we do equity pay?

| Compensation   | Culture   |
|--|---|
| <ul style="list-style-type: none"> <li>• How much?</li> <li>• How often?</li> <li>• Remuneration in line with market practice?               <ul style="list-style-type: none"> <li>- local market</li> <li>- sector companies</li> <li>- multinationals</li> </ul> </li> <li>• Recruitment</li> <li>• Danger of "averaging up"</li> <li>• Employee expectations</li> <li>• Cost/affordability for company               <ul style="list-style-type: none"> <li>- how do we define cost?</li> <li>- recharge costs to Business Units?</li> </ul> </li> <li>• Local country tax breaks - economic distortion</li> </ul> | <ul style="list-style-type: none"> <li>• Employee ownership</li> <li>• Profit sharing or incentive? i.e backward or forward thinking?</li> <li>• Pay for performance?</li> <li>• Defining performance?               <ul style="list-style-type: none"> <li>- measured where? (corporate/BU)</li> <li>- measured how? (internal/external)</li> </ul> </li> <li>• Pay to play?</li> <li>• Who gets what?               <ul style="list-style-type: none"> <li>- all in this together? or</li> <li>- winner takes all?</li> </ul> </li> </ul> |

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• Demonstrating alignment of employee and company interests  
• Justifying differences of approach  
• Demonstrating fairness and consistency up, down and across

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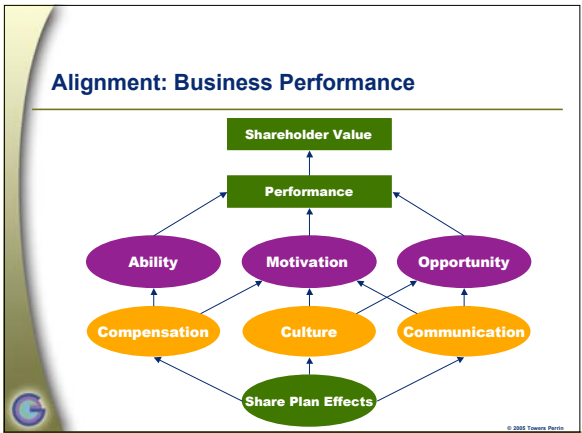
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### Executive Compensation - A UK Chronology

- Base pay, plus directors' shares, circa 1850 to 1940
- Base, plus true bonus (for exceptional performance) circa 1920 to 1975 or so
- Base, plus bonus, plus options: 1980 to 1995
- Base, plus bonus, plus options, plus PSP: 1990 to 2000
- Base, plus bonus, plus options, plus PSP, plus DSP 1995 to 2002
- Base plus bonus, plus LTI (managed as a mix): 2000 ongoing

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### The rise of the mighty option: In praise of options

- Employees only gain if shareholders gain
- No P&L charge (then)
- Simple to communicate and understand
- Risk free for employees



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### Companies around the world are increasing their use of long-term incentives (LTIs)

Estimated Percentage of Companies Offering Long-term Incentive Plans (1997, 2001, 2003)



- By 2003, most large companies around the world had some type of LTI programme
- Local companies have increasingly used LTIs to attract talent
- Most LTI vehicles were option based



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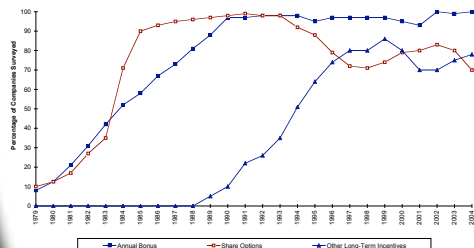
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### The development and incidences of annual bonus, share option and other long-term incentive arrangements in UK companies



Source: Towers Perrin Survey of Top Executive Remuneration 2004



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## FASB

"Council of Economic Advisers, we raised strong concerns about conflicts of interest and problems in accounting standards and practices, particularly as they related to derivatives and options."

"FASB called for a change of accounting practices."

"The Secretary of Treasury and the Secretary of Commerce, however, violated basic principles of good governance, which call for the independence of FASB, and intervened to squash the proposed revisions. They succeeded."

*Capital Hill Hearing, Senate Banking Housing and Urban Affairs  
Review of US Economic Health by  
Dr. Joseph Stiglitz Nobel Laureate Professor of Economics, Columbia  
University*



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## Alan Greenspan

"Regrettably, the current accounting for options has created some perverse effect on the quality of corporate disclosures that, arguably, is further complicating the evaluation of earnings and hence diminishing the effectiveness of published income statements in supporting good corporate governance."

"The Federal Reserve staff estimates that the substitution of unexpensed option grants for cash compensation added about 2 1/2 percentage points to reported annual growth in earnings of our larger corporations between 1995 and 2000. Many argue that this distortion to reported earnings growth contributed to a misallocation of capital investment, especially in high-tech firms."

*Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System  
New York University Stern School of Business, March 26, 2002*



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## So are options dead – what is driving the discussion?

- Accounting for share options
- Mid 90's: bull market
- Recent years: bear market
- Tougher performance conditions required by UK institutions – and increasingly seen elsewhere
- Pressure to drop "re-testing"
- Willingness to assess the number of shares or options to be awarded to deliver the "right" gain for the target/maximum performance levels



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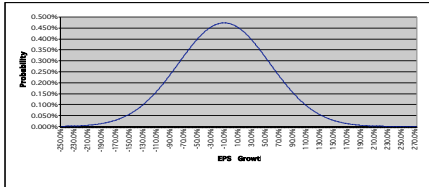
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### Our survey valuations are based on ten-year historical data: performance condition evaluation

For example, the chart below shows the distribution of EPS growth among the FTSE 100 companies



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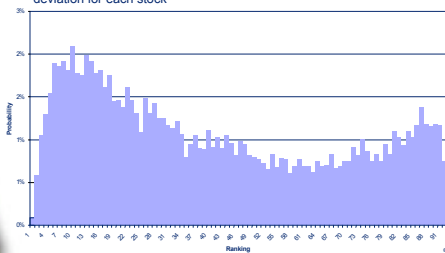
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### Area under the vesting curve – probabilities based on past performance

- Alternatively it is possible to use the past to give us guidance
- Use historical TSR to generate potential rankings
  - The model uses correlation between TSR of stocks, median TSR and standard deviation for each stock



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### And...

...almost all of this leaves executives cold, even if they understand, which few do...

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**Impact of regulation and unintended consequences**

- Company law – governs ability to offer shares
- Tax – sometimes penal, and sometimes favourable, but only for defined plan type
- Investor codes / governance codes
- Impact of disclosure



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**Governance Codes**

- First issued in 1973 by the Investment Protection Committee of the ABI (funnily enough the same year as Black Scholes invent their formula)
- 1992: joint ABI and NAPF guidance requires exercise conditions for all new option plans
- Greenbury report in 1995 mandated listed company disclosure and performance conditions on all option grants
- 1998: Combined Code consolidated guidance and embed the "comply or explain" principal
- 2002: Directors' Remuneration Report Regulations
  - annual vote
  - performance graph
  - reinforced disclosures



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**Governance Codes**

- Similar but lagging patterns as seen in the Netherlands, Germany, France, Sweden, Spain, USA, Canada and Australia
- But none of the remedies seems to fully satisfy the need
  - Executive pay is abnormal
  - And too high
  - For too little performance
  - And not properly regulated
- So more regulation is predicted
  - With equally ineffectual results



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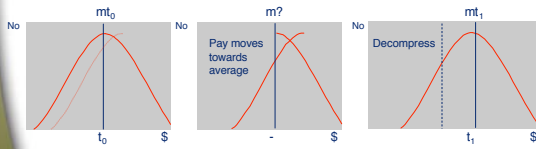
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## Disclosure

Disclosure causes pay inflation. This is because few companies can maintain a "below average" pay stance



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## Corporate Equity Pay: Where does it fit?

|                | Fixed Pay Focus  | Variable Pay Focus  |   |
|----------------|--|---|---|
| High Pay Focus | <b>Top End Government</b><br>• Judges<br>• Generals<br><b>Regulators</b><br>• Central Bank | <b>Entrepreneurs</b><br><b>Capital Markets</b><br><b>Professions</b><br><b>Top end Corporates</b> | "Open ended" opportunity<br>Much is equity based<br>Work for what you get |
| Low pay focus  | Everyone else  | Piece Work<br>Zero hours controls<br>Commission only sales  |   |



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## Pension: Important, complex and diverse

Pension values are huge and rarely understood

- Pension of 50% of final pay may be worth 10 times final pay

Companies have different historical approaches

External forces driving need to change / innovate:

- Government policies changing
- More competitive times
- Governance and shareholder activism
- Cross European (world?) consistency / transparency
- Increased disclosure requirements (e.g., UK, EU)



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### Emerging pension issues

- Executives focus on pension level and differences
- Base, bonus and long-term incentives moving toward reasonable harmonisation, or rationalisation for executives
- Pension is increasingly important to executives - pension differences can no longer be dismissed as allowed for in pay

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### Defined Benefit vs. Defined Contribution

|             | Current Situation   | Trend / Comment   |
|-------------|---|---|
| Belgium     | 80% DB; 20% DC+   | New plans are mostly DC   |
| France      | 90% DB  | Historic tax reasons; new law → to hybrid                       |
| Germany     | 85% DB - Board Members<br>60% DB - 2 <sup>nd</sup> level Executives | 2 <sup>nd</sup> level Executive Plans moving from DB to DC type |
| Italy       | PREVINDAI is DC   | Few beyond PREVINDAI  |
| Netherlands | 70% DB; 30% Hybrid / DC   | Limited trend to Hybrid & Career Average DB                     |
| Spain       | 75% DB; 25% DC  | Moving to DC, especially for new entrants                       |
| Sweden      | 60% DB; 40% DC  | Trend to DC, especially for new entrants                        |
| Switzerland | 80% DC; 20% DB  | Continued movement to DC  |
| UK          | 40% DB; 40% DC; 20% other   | New plans mostly DC; tax reform influences                      |
| US          | 80% DB; 90% DC  | Move toward DC (including Cash Balance)                         |

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### Pensionable Earnings

|             | Definition   | Trend / Comment                |
|-------------|--|--------------------------------|
| Belgium     | 50% (Base only) ; 50% (Base + Bonus)                                     | Pressure to include Bonus      |
| France      | Base + Bonus   | A few ceilings (e.g. 65 x SSC) |
| Germany     | Senior Executives: 60% (Base + Bonus)<br>Board Members: 100% (Base only) | —                              |
| Italy       | Base + Bonus   | —                              |
| Netherlands | DB plans use Base only   | Some DC / Hybrid include Bonus |
| Spain       | Base only (a few exceptions)   | —                              |
| Sweden      | 60% are Base + Bonus   | —                              |
| Switzerland | Base + Bonus (via DC Plan)   | —                              |
| UK          | 90% are Base only  | No trend to include Bonus      |
| US          | 85% are Base + Bonus   | —                              |

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**Globalisation and IT Effects**

- Better disclosure combined with IT/Internet access allows cross border / global pay comparisons to be made much easier
- Western / US business values and lifestyles mean global cities are reasonable places to live, fostering international travel
- The rise of the global capital markets means that shareholders are demanding the same kind of corporate performance and governance in many jurisdictions
- Increasingly firms are willing to hire and executives are willing to travel, so the foot print of executive search is getting much bigger
- Expatriate employees are fast becoming history, to be replaced by the global executive and the more flexible and more junior equivalent, the international mobile employee (IME)
- For the lower paid, offshoring and economic migration are forces keeping "normal" pay lower than otherwise.
- The upshot is executive pay is rising at a faster rate than normal pay.

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**Some predictions**

- Executive pay will continue to rise and rise at a faster rate than general pay
- Much of this growth will remain performance related and equity based
- Performance vesting will simplify and will start to focus on the absolute delivered result, not relative performance
- There will be a dilution battle:
  - if corporates "win", then dilution levels will rise and become more diverse
  - if not, phantom plans and cash based LTI will rise rapidly

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**Is incentive pay immoral : the 7 deadly sins?**

|            |         |
|------------|---------|
| • Greed    | • Wrath |
| • Pride    | • Envy  |
| • Sloth    | • Lust  |
| • Gluttony |         |

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### Is incentive pay immoral : the 7 deadly sins?

- Performance pay works because of **GREED** and **PRIDE** – the desire for more money combined with the feeling of winning and self worth. The combination is the antidote to **SLOTH**
- **GLUTTONS** will always want more and more, no matter how much you give them
- However, incentive pay invokes **WRATH** and **ENVY** in others – which disclosure has made much worse.
- So far only **LUST** has been kept out of the equation (but then again, diamonds are a girls' best friend!)



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### Questions?

Thank you for your participation



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