

Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis

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INTRODUCTION

Research approach

- Analysis of directors' remuneration system in light of
 - Regulatory framework
 - Corporate governance best practices
- Overview of regulation
 - Community level
 - Member States
 - Common rules
 - Divergences
- Remuneration governance and disclosure in European firms

EXECUTIVE PAY AS A PROBLEM

Agency Problem

The theory

Misalignment of management and shareholder interest in dispersed ownership system

Blockholders' motives to monitor the managers may lower the need for an incentive contract

Legal controls on executive pay exist in both ownership systems

Agency costs

Conflicts between the board (as pay-setter) – and shareholders

Perverse incentives to manipulate earnings and stock prices

Social Problem

Traditionally

Alignment of board interest with shareholder interest

Extended view

Maximising shareholder value

Social implications of wealth and power

Trend

Shareholder activism  Stakeholder concern

Lessons from the Crisis

Across sectors

Pay gap top management – other employees

Pay contracts allowing rewards for failure

Short-termism

Conflicts of interest in the remuneration process

Insufficient disclosure

Specifically financial institutions

Perverse incentives encouraged excessive risk-taking

No consideration for remuneration below board level

Lack of supervision

CURRENT REMEDIES

Role of Independent Board

Dispersed ownership

Closing information gap between shareholders and top management

Blockholding

Protecting minority shareholders

- ✓ Improves shareholder control over remuneration
- ✓ May decrease the need for further regulation

Remuneration Committee

Increases efficiency of the (supervisory) board

Reduces conflicts of interest

Separate remuneration committees; may be joined with nomination / audit

Composition: exclusively non-executive, majority independent members

Member States

- 'Comply or explain' basis
- Differences in regulation (mainly composition requirements)

Germany: no Remuneration Committee

Say on Pay

Vote of (no) accountability of the board

Remuneration policy

Explicit item on the AGM agenda

- binding / advisory (UK, Spain, Netherlands, Sweden)

Share schemes

Approval needed prior to their adoption

Vote to re-elect directors

Disclosure: Remuneration Policy

Forward-looking remuneration policy

Clarity on the link remuneration – performance

Methods for performance evaluation

Understanding directors' pay contracts

Member States

Generally regulation doesn't require separate remuneration reports

Differences in disclosure requirements

Disclosure: Individual Remuneration

Individually execs & non-exec

- ✓ Fixed
- ✓ Variable pay
- ✓ Share-based incentive schemes

Member States

Introduced high disclosure standards

Mostly mandatory

Some countries still only provide executive remuneration as an aggregated amount (e.g. Austria, Belgium, Greece)

DESIGN

Terms of Contracts

Avoiding rewards for failure by:

- Caps on severance payments
- Making them conditional on achieved performance
- Ban golden parachutes in case of failure
- Clawback provisions

Member States

Few have adopted limits to service contracts for executives

Few have adopted caps on severance payments

Pay Structure

Balance between fixed and variable pay

Balance between long and short term performance criteria

Deferment of variable pay subject to performance conditions

Guidelines for **terms of share-based schemes**

Minimum vesting period for stock options

e.g. UK, France, Belgium, Netherlands, Luxembourg: 3y

Vesting & exercise of share options subject to performance conditions

Retention of part of shares until the end of mandate

Financial Institutions

- Risk-adjusted performance criteria: current & future risks
- Performance criteria accounting for cost of capital and liquidity
- Increased role of supervisory authorities
- Appropriate balance core pay – bonus
- Withholding bonuses when performance criteria are not met
- Remuneration governance involving internal control functions
- Remuneration policy covering all staff with risk profile

RESEARCH ON COMPANIES

Assessing disclosure and remuneration governance

Dataset

FTSEurofirst 300 components (market cap); 16 EU countries

Methodology

3 areas:

- Governance
- Remuneration policy
- Individual disclosure

23 criteria following the two EC Recommendations (2004-2005)

- Recommendation on directors' remuneration
- Recommendation on the role of non-executive directors

Overall analysis

Firms tend to follow national regulation rather than Community recommendations

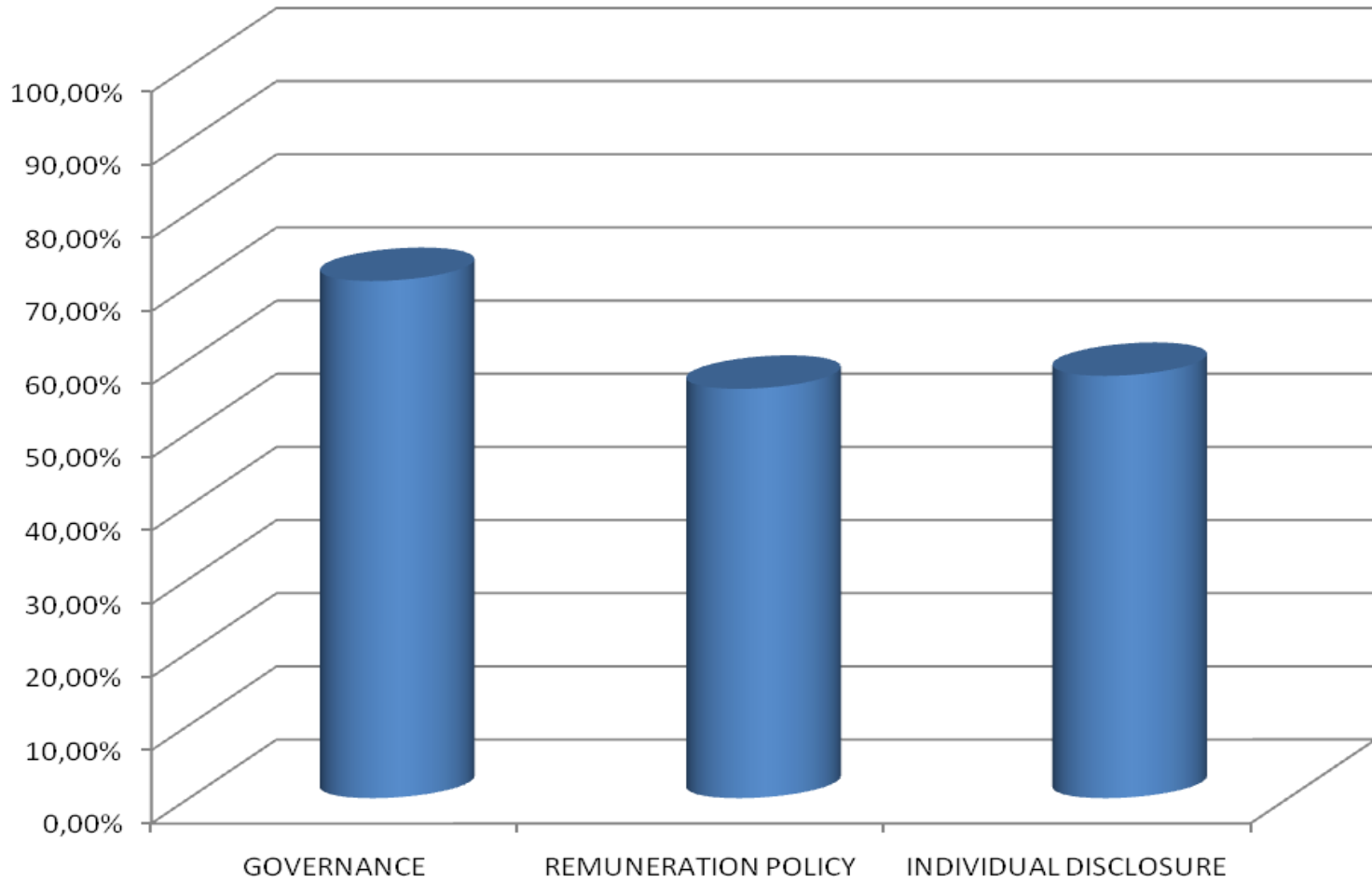
Disclosure varies between firms from different jurisdictions

Criteria: various degrees of importance

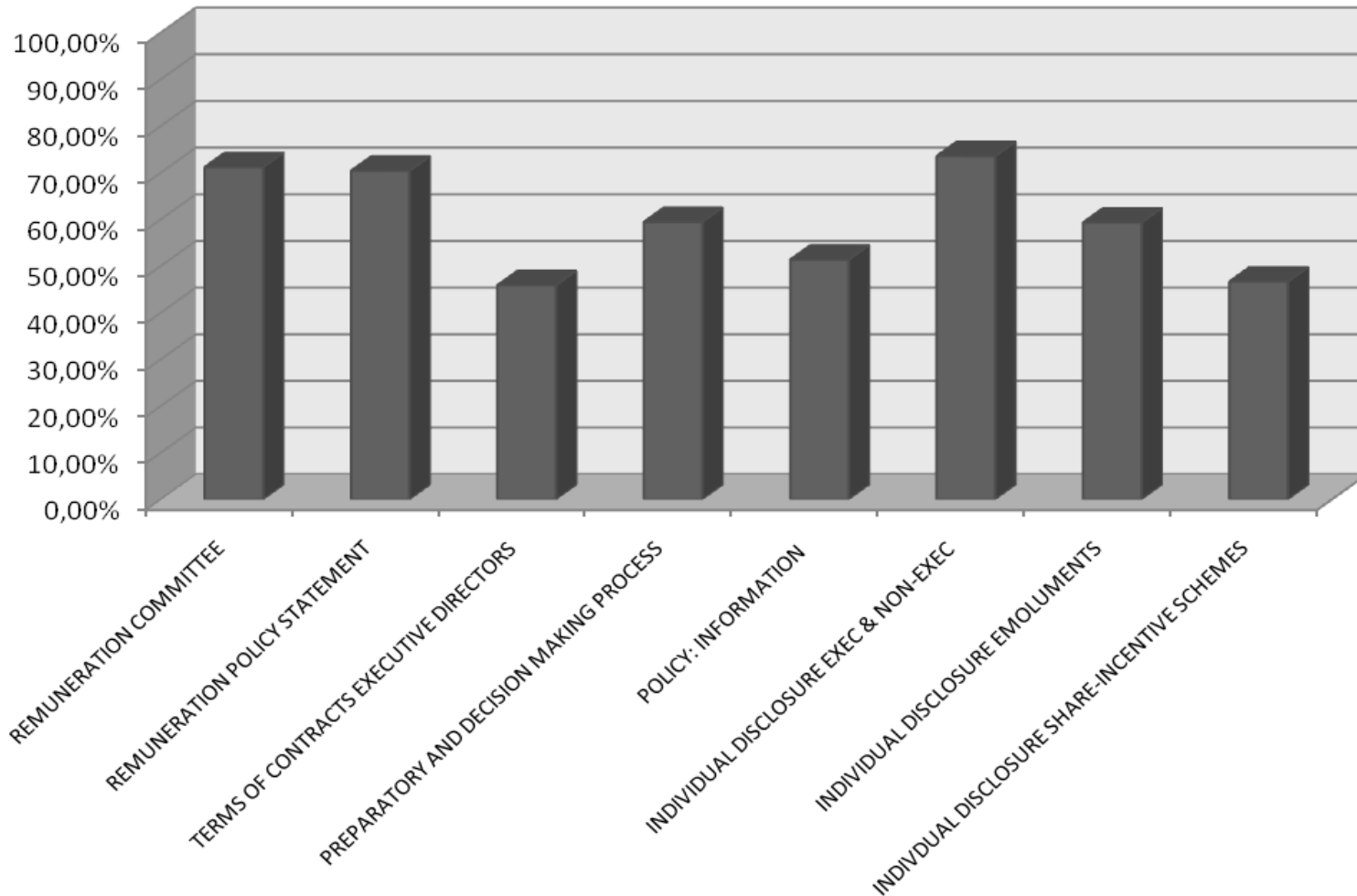
Highest importance: basic requirements

Lower importance: requirements for more detailed information

Three main areas



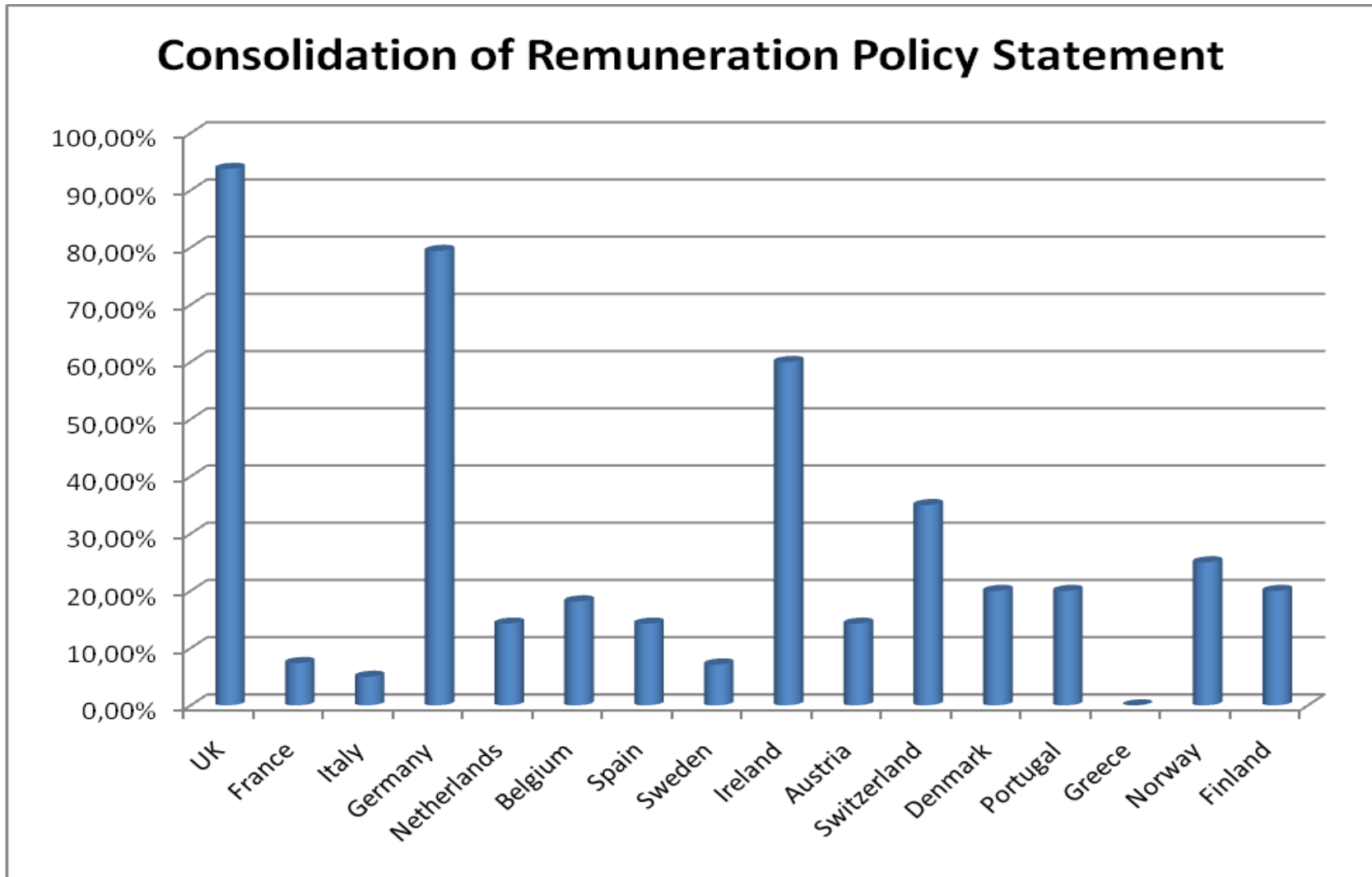
8 Categories



Highest: Individual disclosure , Remuneration Committee

Lowest: Disclosure terms of contracts for executive directors

Continental Europe: elements of the remuneration policy are scattered throughout the AR



POLICY ISSUES AND REFORM PROPOSALS

Governance

- Independence in the remuneration process
 - Remuneration Committee
 - External consultants

Disclosure

- Rules for consolidating all information pertaining to remuneration policy
- Standard reporting format
- Quality over Quantity

Remuneration policies

- To reflect principles, strategy and objectives of the firm
- In line with the control systems of the firm (financial institutions)

Application of rules

- Scoreboard for monitoring firms within each MS
- Core requirements: binding law
 - e.g. individual disclosure of remuneration, say-on-pay

Complementary framework disclosure-governance-design

CONCLUSIONS

- Interlink: Disclosure – Board – Say-on-Pay
- Remuneration governance understood as an opportunity, rather than an obligation or a pure cost factor
- Shareholder involvement – need for increased disclosure
- Comprehensive disclosure supports reputation of the board
- Adoption of other CG principles – precondition for sound compensation system

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