

FINAL CALL: NOW BOARDING! **Expressing Employees' strategic interests in Europe's boardrooms and the European Internal Market**

Report from the working group: Reorienting executive remuneration towards employees' interests and sustainability

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Moderator

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Sigurt Vitols' primary research topics include Corporate Governance, worker participation, financial regulation and economic policy. Up until November 2010 he was a Senior research fellow at the WZB (Wissenschaftszentrum Berlin für Sozialforschung). Together with Norbert Kluge, he is currently co-editing a book on the Sustainable Company, which presents an alternative to the shareholder value corporate governance model of the firm.

Sigurt Vitols introduced the working group session by recalling the key concerns about executive remuneration, i.e. the issues of transparency, level and structure of their compensation packages.

Panel

Camiel Selker, Lintstock partner, camiel@selker.com

Up to this summer, Camiel Selker was heading Towers Perrin pension and remuneration consultancy in the Netherlands. He now continues to advise supervisory boards, in partnership with Lintstock. He is an expert on integrating ESG (Environment, Social and Governance) elements in performance criteria.

His presentation focused on the question how to build sustainable incentives. While observing that executives' incentives increasingly include sustainability, he also stressed that this reorientation was still too often used as a window dressing or for public relations purposes, without any real consideration for a new measure of performance and a new adaptation to company's business model. His observations led him to rather promote the "stewardship model", i.e. performance-based executive incentives where performance has to be seen as collective rather than individual; long-term focus instead of short-term based; involving stakeholders thanks to, amongst other, employee involvement fostered by good human resources practices.

Roland Köstler, Lawyer at the Hans-Böckler Foundation, roland-koestler@boeckler.de

Since 1978, Dr. Roland Köstler is a legal expert in company law and worker participation at the Hans Böckler foundation. Being a recognized expert in this field, he contributed to several federal commissions on the Corporate Governance issue in Germany. Moreover, he is serving as board member for many years in several supervisory boards of German companies.

Roland Köstler reported on debates dealing with executive remuneration which are taking place in Germany. The most prominent novelty is the promulgation of the Appropriateness of Management Board Remuneration Act (Gesetz zur Angemessenheit der Vorstandsvergütung), which came into effect on 5 August 2009 and introduced a shift of responsibilities in the decision-making of remuneration measures from remuneration sub-committee to the entire board, including board-level employee representatives. This Act also stresses the obligation for executive remuneration to be linked with sustainability and long-term perspectives, while introducing claw back possibilities. Roland Köstler also presented the positioning of German trade unions on this issue as well as the Hans-Böckler Foundation's recommendations towards board-level employee representatives on this issue¹. He also detailed an example of good practice which is the use of a mix of elements in determining company's performance (e.g. satisfaction of customers, satisfaction of employees, health and safety policies, jobs quality, environmental consideration, etc.) and linking it with management remuneration at Volkswagen.

¹ which can be found at http://www.boeckler.de/pdf/ah_ar_14.pdf

Report from the discussion

A point of consensus

All participants agreed to state that stock-option based remuneration proved to fail and to be a strategic error since share prices, even being the easiest performance measure to get access to, do not reflect the company's interest, i.e. both shareholders and stakeholders' interests. Moreover, this quantitative performance measure is helpless in considering qualitative dimensions of company's performance.

Some points of debates

On the issue of executive remuneration, several questions have been raised which are still to be discussed:

- Should the debate on reorienting remuneration towards sustainability and fairness only cover the specific topic of executives' remuneration? What about lower levels of the managerial hierarchy such as middle-management, or top management in daughter companies? What about the remuneration of employees who can also legitimately claim for bonuses in the event of good company's performance and who are, in a knowledge-based society, an active player in the creation of added-value?
- So far, the debate on executive remuneration focuses on financial institutions or large and listed companies. What about all the other companies, composing the main part of an economy?

Discussion on key dimensions of executive remuneration

1/ Transparency

- ⇒ The disclosure of individual rather than grouped remuneration of executives is still an issue. In Germany, a 2005 Act still allows companies to avoid disclosing the individual remuneration of top managers.
- ⇒ The quality of the disclosed information on remuneration is still questionable as executives compensation packages are still far too complex to understand for members of the General Shareholders Meeting [GSM henceforth], and even for board members themselves.
- ⇒ The use of "Say on pay" mechanisms does not help. There is no sound evidence of its effectiveness in regulating executives' remuneration.

Moreover, GSM rather has a say on remunerations' structures than on their levels. Finally, granted the "say on pay" right to the GSM could lead to take away board's responsibility on this matter.

2/ Structure

The main part of discussions dealt with the introduction of Long-Term Performance Incentive [LTPI henceforth]. Whilst recognized as a welcome advance in regulating executive remuneration, a set of questions quickly arose:

- What is "long-term"? Giving two new and fresh European legal texts (the Capital requirements Directive² and the Directive on Alternative Investment Fund Managers³), long-term is delimited to a time period lasting from 3 to 5 years. Indeed, into these two pieces of European legislation, some provisions related to remuneration policies, and more specifically to a deferred proportion of the variable remuneration component, state that the period of deference should not be less than three to five years so as to link it with a sustainable conception of the business activity. Moreover and once the end of the period of deference reached, the total variable remuneration could be considerably contracted in the event

² Annex V of the new Directive amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (forthcoming publication in the Official Journal) specified the following:

- a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question;
- the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned. Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

³ Annex II "Remuneration policy" of the Directive on Alternative Investment Fund Managers and amending directives 2003/41/EC and 2009/65/EC (forthcoming publication in the Official Journal) specified the following:

- a substantial portion, which is at least 40 % of the variable remuneration component, is deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned and is correctly aligned with the nature of the risks of the AIF in question. This period should be at least three to five year unless the life cycle of the AIF concerned is shorter
- the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned; the total variable remuneration is generally considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or claw back arrangements

of under-performance. However, these same provisions stress the fact that this period of time has to be considered as a minimum and should be adapted according to “the nature of the business, its risks and the activities of the member of staff in question”. According to which criteria? This remains an unclear element of these new legal provisions.

- How to measure “performance” since it relies on a combination of several variables? What non-financial indicators should be included in the measure of company’s performance? For instance, employee representatives from GfK SE reported the practice of the management conducting an internal survey on employee satisfaction so as to include the findings as a non-financial indicator. **But**, report from the same practice formerly handled at Fortis leads to question its real effectiveness.

3/ Level

Several ideas and recommendations have been discussed. However, each of them led to the rise of other difficulties:

- Rising up the fix-part of remuneration and guaranteeing a better link of the variable part with sustainable performance. **But**, most of the time, board decision touches upon the fix-part of the remuneration and more rarely upon variable components. Moreover, there exist a lot of diverse means to circumvent regulation on variable components like, for specialized consulting firms to develop more complex and hidden variable schemes.
- Imposing a ratio between top executives’ remuneration and the average remuneration of workers, as it is nowadays discussed at the European level for the specific situation of financial institutions and in the legislative background in the new German law. **But**, here arises the question of the calculation of the average workers remuneration: who are the workers included in the calculation? Does the average include managerial staff as well? Does it include only national workers, or the international workforce of a multinational company [MNC], which can make huge difference for a US MNC operating in low wages countries?
- Imposing caps on executive remuneration as claimed by some German trade unions. **But**, the German constitution can prevent from implementing such measure. Moreover, setting up such a legally mandatory cap would require the establishment of monitoring and supervisory authorities so as to ensure the enforcement of this principle, and not only in financial institutions. Therefore the solution could be more in the field of taxes.

- Introducing systematic claw back clauses: a percentage of the variable remuneration must be deferred for a fixed period of time and will only be paid if justified by good company performance. But, here again, consulting firms prove to be very creative in developing tailor-made financial products for CEO which guarantee their revenue, even in the event of performance objectives not being met.

Potential recommendations

Given the complexity of the debate, participants didn't end up with strong and clear-cut recommendations, but rather with potential tracks to be followed:

- Executive remuneration should be tailor-made depending on the business model of the considered company. There is no "one best way" when it comes to fix and decide on top management compensation packages. However, some "universal" elements and indicators to link the remuneration with could be well applied by all companies such as environmental indicators (gas emission, local pollution, etc.).
- A binding legislation is strongly needed. Self-regulation and soft laws (e.g. Corporate Governance Codes) proved to be meaningless in regulating executive remuneration. Without a strict legal framework the trend of a return to "Business as usual" as it emerges, will go on.

Conclusions

The trade union movement is facing two great challenges:

- Imposing the shift from a situation where share prices were the main and only element driving executive remuneration, to a situation where share prices are only one of the numerous indicators determining remuneration;
- Being as creative and innovative as all those actors developing complex instruments for hidden incentive schemes.