

Frankfurter Allgemeine

ZEITUNG FÜR DEUTSCHLAND

Monday, July 30th, 2018

Incentive to do the right thing

The subject of remuneration for management board members, severance payments or pension rules for managers, tends to fuel passions time and time again. A good remuneration regulation must be transparent, appropriate and comprehensible. By Rolf Nonnenmacher, Wulf von Schimmelmann.

Investors and shareholder advisors are increasingly questioning the management board remuneration packages offered by German companies around the dates of annual general meetings; such questioning is occurring behind closed doors as well as in public forums. Yet irrespective of such challenges, the issue of the correct incentive model for management board members is right back at the top of the legislator's agenda again. Ultimately, it is a question of implementing the European Shareholders' Rights Directive into German law. This must be drawn up in the coming weeks, and be implemented by 10 June 2019 at the latest. Management board remuneration plays a key role here, too. Regardless of how German legislators may decide – whether shareholders' vote on management board remuneration at the annual general meeting should be binding or

not – the decisive factor is what should be submitted for voting in the future.

Furthermore, it must be taken seriously if so many different people have a problem with the issue of incentive models for management board members.

The fundamental question is in fact very simple: it is a matter of attracting the right management board members and then also motivating them to do the right thing. The incentives and rewards inherent in satisfactory management board remuneration are crucial factors in defining and implementing a company's business strategy. The remuneration of management board members is therefore one of the key roles of the supervisory board, at the very heart of corporate governance.

However, every remuneration system is only any good if it is understandable. Therefore, if the remuneration report alone needs fifty pages to be explained, this can hardly be expected. Above all, management board remuneration must be acceptable to (and meet with consensus in) the company, and in general society. Cohesion within companies and in the public realm, as well as the responsibility of the management board members, play a key role in this respect.

The focus here is on the decision concerning how much a management board member should earn – and in particular, for what, and how this is disbursed. This can only be assessed by the companies themselves. It means they all face some fundamental questions: how high should the overall target remuneration be to attract the right management board member? How much of it should be performance-related? What measures must be taken to ensure the amounts granted really are truly variable, and correctly reflect the operative and – most importantly – the strategic performance during a given period? And finally, in what way could the successes of this original performance impact on individual management board members at a later stage? Let's look at some suggestions.

1. TOTAL COMPENSATION – How much should an executive be able to make?

Each management board contract should govern the amount of remuneration a management board member will receive in the individual contract years, if all targets are met in full (total remuneration target) and what the maximum amount should be (total remuneration cap).

Regardless for what performance (and in what form) a management board member is paid, the expected value and maximum potential of the overall remuneration are the factors determining the positioning. In fact, the primary issue is not whether the defined benefit plan or the bonus program are still up to date, but whether the total remuneration amount is appropriate.

Theoretically, this is easy to determine. The amount depends on the value the management board member creates for the company, and on what really is necessary to attract or retain said member. Nothing more and nothing less.

In practice, however, the decisions to be made concerning the overall remuneration (target and

cap) are considerably more complex. The starting point is the desired profile of the executive. The relevant peer groups in the market can provide an indication as to what similar companies pay for comparable positions. Nonetheless, a purely mechanical comparison frequently leads to an automatic upward trend and must therefore be avoided.

Ultimately, the desired integration in the company – and within society – is important for determining the amount of the overall remuneration. Within the company, the gap to other executives and employees must be acceptable and communicable. As far as the general public is concerned, the appropriate social classification and acceptance are factors against which the amount of remuneration needs to be assessed.

2. COMPENSATION STRUCTURE – What share of the total compensation should be performance related?

Within the total compensation, the key question is how much of it should be variable.

Every compensation package comprises fixed and performance-related components. The fixed component includes monthly salaries, pension contributions and non-operational fringe benefits. The performance-related component comprises of short-term (bonus) programs and the long-term incentive plan.

A very conscious decision should be taken as to the weighing of performance-related versus fixed remuneration. The ratio should reflect the company's performance culture as well as the desired executive's profile. Fast-growing and diversified companies tend to feature higher performance-related components, which also often goes for executives who run profit centers. Central functions such as finance and law often show a higher fixed portion.

The split into fixed and variable blocs also allows for some direction decisions. At low fixed blocs

pension schemes, for example, might become less sought after because they might “eat up” too much of that bloc. Or, within the performance-related bloc, long-term elements might be deliberately given a significant overweight to strengthen the strategic focus.

3. VARIABLE COMPENSATION – How can the long-term orientation be incentivized?

Variable compensation is the most important arsenal for pursuing the company’s objectives and for taking the right actions. Targeted incentives and rewards will encourage the executive to run the company today operationally successful and in particular to make it “fit-for tomorrow”. A lack of genuine incentives and rewards will generate a contrary outcome.

The achievement of objectives cannot always be measured precisely, but must be verifiable in any event. The calibration of objectives and resulting variable remuneration should be determined ex ante, and may not be changed subsequently.

Above all, variable remuneration must mean variable. The variable amount granted for a specific period should remunerate the performance rendered by the executive in exactly that period. Strong performances should be rewarded. Poor performances should not be 'penalised' – but not be rewarded either. Payments should never be taken for granted.

The ratio of short to long term incentives will differ from company to company. Short term objectives are intended to impact on the current situation. Strategic measures are taken in the respective year, but their successes will occur on a longer-term horizon. In fact, they often burden the financials of today for the benefit of tomorrow. As they have to shape the future they should in most cases be outweighed within the performance-related remuneration.

Operational metrics are the core of the short-term variable remuneration. They will include financial parameters such as EBITDA, margins, and productivity figures as well as non-financial parameters like net-promoter score, employee commitment, and social responsibility yard sticks. The amounts granted on the basis of achievements should be paid out in cash at the end of the period.

Long term variable remuneration should be all about strategy. A company’s strategic plan comprises of critical milestones for each of the years ahead. The implementation of the respective milestones (annual strategic agenda) is what should govern the executive’s payment for that year – variable and performance-based in the best sense of the word. As financial success usually becomes visible only much later, the amounts granted should be paid in shares of the Company. To give enough time for the market to judge, the shares should not be sold for at least four years.

4. MISCELLANEOUS – What else needs to be considered?

Executives should get what they deserve. And they should place themselves entirely at the service of the company.

This means that amounts paid out may be reclaimed in justified cases and that the Supervisory Board should have the option to take appropriate actions if extraordinary circumstances might occur in both directions. All accruals and blocking periods should remain in place after retirement/resignation from the company.

It often makes sense for an executive to gain further experience by assuming board mandates outside the Group. However, the number should be strictly limited and the Supervisory Board should decide on whether remuneration is to be offset in each individual case. Executives should not chair supervisory boards of non-group companies

5. SUMMARY

Executive compensation should create the right incentives for the executive to take the right actions, to compensate him/her adequately for the performance rendered, to respect social acceptance and to explain clearly and understandably how much and for what he/she gets paid. Any compensation scheme had better defined the total target compensation, the relative share of fixed and variable remuneration blocs and the calibration between

previously agreed targets and rewards. Long-term variable grants should be variable at the time they are rewarded, and above all act as an incentive for implementing strategic moves.

© All rights reserved. Frankfurter Allgemeine Zeitung GmbH, Frankfurt. Provided by Frankfurter Allgemeine Archiv.

Translation arranged by the Secretary of Regierungskommission Deutscher Corporate Governance Kodex.