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-execs

- 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
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
• 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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