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FINANCIAL NEWS

Shareholders come out of their shells

Reform of pay is speeding up after years of slow progress

Institutional investors will have to take on an active governance role, writes Mark Cobley

In May last year, Dermot Gleeson, chairman of the bailed-out Irish banking group AIB, was pelted with eggs at the company's general meeting. It was a mark of one of the most acrimonious years in investor relations in recent times – but experts say 2010 could be worse.

John Wilcox, a partner at investor relations consultancy Sodali, said: "In 2009, everyone was still in the thick of it, and investors were distracted. I think the year ahead will be worse for dissent, unless companies do a very good job of designing directors' pay packages to avoid risk and prioritise long-term value, and explain how they are doing this very well to investors."

The dust of the credit crisis will take a long time to settle. A great deal of anger was vented at company boards last year, and not just by egg-throwers, but by mainstream institutional shareholders.

As ever, remuneration is the issue that focuses minds. In the UK, four companies were defeated on pay votes – only the second year that has happened. Many more suffered smaller rebellions.

Sarah Wilson, chief executive of proxy voting adviser Manifest, said: "This year shareholders will want to see that management have been restrained on pay. There will also be a focus on things like dividend policy, to make sure they are not paying out all the company's cash."

One of the four companies to suffer defeat on its pay policy last year was Royal Bank of Scotland, after the UK Government's investment manager, UK Financial Investments, voiced its disapproval of a £16.6m pay-off to former chief executive Sir Fred Goodwin and £1.4m to the former head of investment banking Johnny Cameron.

But if RBS' current executives thought this year's bonus plans would be less contentious, they were mistaken. The bank's plans to pay out a bonus pool of up to £1.5bn provoked controversy and outrage, and directors might now have to accept packages tied to the worth of the assets insured in the Government's Asset Protection Scheme.

But the wider banking world can also expect more scrutiny on pay in 2010. The UK is leading the charge. Sir David Walker's review has called for four-fifths of bonuses to be paid in deferred compensation rather than cash, and for banks to make much greater disclosure – though anonymised – on the pay levels of senior staff. Meanwhile, the UK Government is planning a windfall tax on bonuses and also wants to give the Financial Services Authority greater powers to control and block remuneration.

Banks' woes are having a knock-on effect in other sectors. The Financial Reporting Council is in the process of overhauling the company rulebook, the UK Corporate Governance Code. It has reiterated the importance of linking pay to risk and, for the first time, put forward the notion of clawing back bonuses in cases of failure.

This deluge of pay reform is likely to keep fund managers busy. Another of Walker's big ideas, which has gained widespread support, is a new set of governance rules for investors, to sit alongside the rules for companies.

Anita Skipper, director of corporate governance at Aviva Investors, said: "Walker has thrown down the gauntlet for shareholders. The Institutional Shareholders Committee has now drawn up this code, and the Financial Reporting Council has agreed to oversee it. For Aviva Investors, we are going to be working towards contributing to the development of this code throughout next year."

The stewardship code will, in all likelihood, involve fund managers being audited in some way on their effectiveness in holding company boards to account, according to Skipper.

Aviva will be pressing for improved disclosure on pay, particularly how performance-related awards are calculated so that they can easily be assessed and compared. It will also be thinking about improvements to bonus targets.

Wilson said Manifest was thinking in a similar direction: "We would be looking to see if companies are using more strategic targets – not merely earnings-per-share or total shareholder returns, but metrics like business growth. Some investors may prefer pay to be linked to non-financial targets such as health and safety standards, or carbon emissions."

Others are coming up with fresh ways to measure performance, to deal with a perception that directors' pay packets have not sufficiently reflected the losses suffered by shareholders and the pain being felt in the wider economy.

The pay packages of the UK's 100 top company bosses rose 7% in 2008 to an average £2.6m, according to Manifest's remuneration report, in a year when the FTSE 100 dropped by 31% and the country's average wage stayed flat at about £24,900, according to the Office for National Statistics.

Manifest's remuneration consultancy partner, MM&K, has teamed up with the Swiss financial research firm Obermatt to promote an alternative method of calculating bonuses. Obermatt's approach is based on companies' operating profits, rather than budgeted profits as is the case at the moment. Companies' profitability is then compared to that of an international peer group, and bigger bonuses are awarded for outperformance.

Cliff Weight, UK representative for Obermatt, said the existing standard "allows people who are good negotiators to negotiate softer performance targets. This gets away from that."

Manifest will be holding companies to this standard from next year – and Weight said he was in discussions with several FTSE 100 boards about introducing it. At first glance, the methodology might appear unappealing to directors, but Weight said that according to his rankings, 70% of directors in the FTSE 100 would deserve bonuses next year – compared with 30% in Germany's Dax 100.

Voting advisers under the microscope

In November, the Securities and Exchange Commission, the US market regulator, signalled the scope of its newest investigation into market practice – the role of the proxy voting advisers.

These advisory firms, particularly market leader RiskMetrics, wield a great deal of power. Some companies and domestic investors in countries where US investors have a big presence on shareholder registers, such as certain European markets and Japan, argue that US mutual funds tend to vote blindly in line with RiskMetrics' recommendations.

The US Chamber of Commerce has also criticised RiskMetrics. It argues the adviser's business model is compromised by conflicts of interest, since the firm offers both voting advice to investors and consulting services to companies on how to deal with shareholders.

In a speech on November 4, SEC chairman Mary Schapiro said the agency would "probe the need for rules to ensure that advisory firms are basing their research and recommendations on accurate and reliable information, and that they are providing adequate disclosure of any conflicts of interest they may have in providing voting recommendations."

A spokeswoman for RiskMetrics said: "We acknowledge that the potential for conflict exists as it does in many businesses. Therefore our focus is to manage this potential, to minimise the risk of actual conflict occurring, through robust internal and external firewalls and transparent disclosure of our business practices on our website."

Views From the Top

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David Barnes, (pictured left), global head of corporate, Linklaters

What is the biggest risk currently facing the global financial community?
Over-regulation. There is a need for measures to prevent another financial crisis. However, some of the proposals from the major economies are worrying. Creating layers of paper and punitive taxes will damage the efficiency of the markets.

What is your New Year's resolution?
It is has been a horrendous year for the financial community. However, with a new year and a new decade, we can allow ourselves to be more positive about the future. I am going to look to the new year with some cautious but firm optimism.

Jeremy Coller, founder and chief investment officer, Coller Capital

What is the biggest risk currently facing the global financial community?
The biggest risk is that some form of Glass-Steagall act is not reintroduced globally. Failure to separate utility banking from its racier cousins will bring on another crash.

What is your New Year's resolution?
To develop a strategy for my new ambition – to live to 100. My wife says I have got a lot of work to do!

Daniel Simpson, chief executive, Cadis

What is the biggest risk currently facing the global financial industry?
Counterparty risk still haunts many financial institutions. Tackling this issue will take time because it has to be done internally – you can't buy this kind of data off the shelf. Firms have made progress over the last year but plenty more needs to be done as boards, investors and regulators expect them to be able to quantify their counterparty risk.

What is your New Year's resolution?
Be more proactive. There's still a lot of uncertainty as to when regulation will kick in or when assets under management levels will return to pre-crisis levels. 2010 is about taking advantage of opportunities and being miles ahead when we finally know what the road ahead will be.