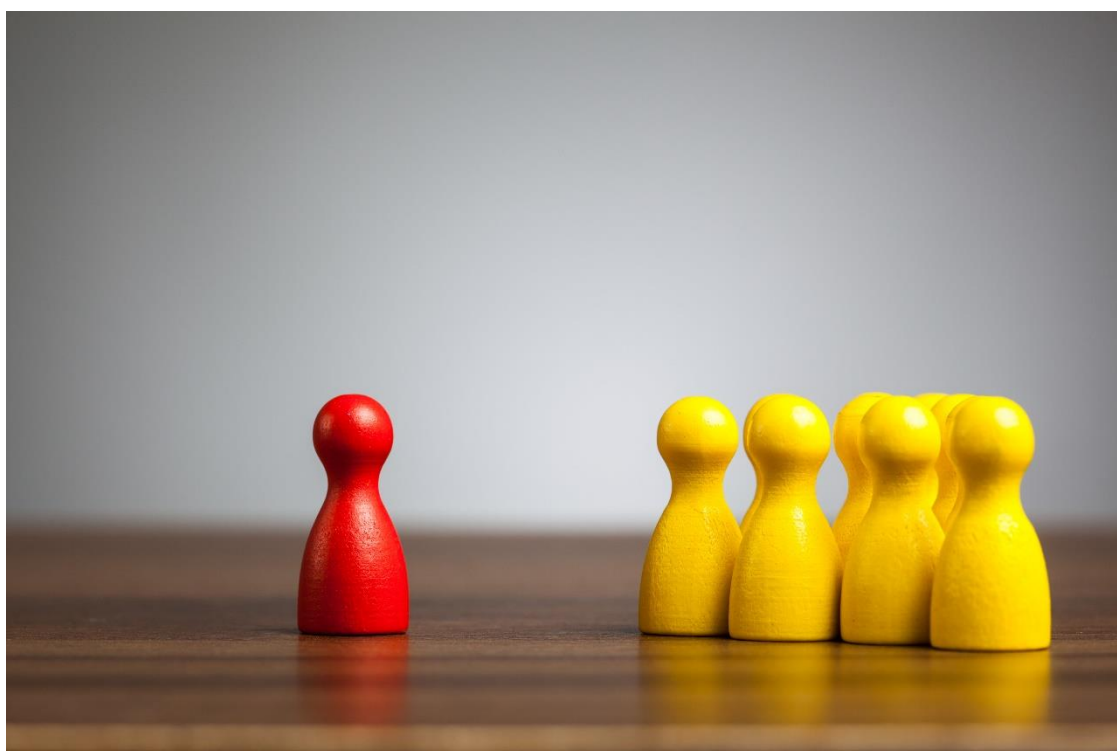


Investors seek better clarity on CEO pay

Remuneration has become a hot button issue for investors. Nomination and Remuneration Committees (NRCs) are failing to align executive pay with company performance. NRCs must make better disclosures while seeking shareholder approval on executive pay. This will improve governance around executive remuneration and provide more clarity to investors: after all, disclosure can be an effective enforcement tool.



CEO pay has been increasing at a quicker pace than profits. While this issue has been building up over the past, FY21 has seen egregious increases in executive remuneration – several at the cost of employee paycuts or headcount reductions (or both), even as some industry leaders took voluntary pay cuts. A 2021 IiAS study of CEO pay of S&P BSE 100 companies suggests that in just 34 companies, CEO pay was aligned to company performance (revenues and profits over a three-year period). In 40 of the 100 companies, the CEO pay was higher than the company’s revenue growth and profit growth. For the remaining 26 companies, CEO pay was aligned to either revenues or profits, but not both.

Recently, for Hero Motorcorp Limited, Pawan Munjal’s remuneration, estimated at almost Rs. 950 mn for FY22 was approved by shareholders with the promoters voting in support of the remuneration, even as 78% of the institutional investors’ votes were cast against the remuneration.

Although very few resolutions in this category were defeated in FY21, several faced investors' push-back. This is a pointer that remuneration resolutions are steadily becoming critical to investors and need more focus.

Remuneration is the responsibility of the nomination and remuneration committees (NRC), but the NRCs, at least to investors, appear detached regarding setting CEO remuneration, including the accompanying disclosures in the resolutions being presented to shareholders.

Shareholder resolutions are drafted by secretarial teams with a view of providing as much flexibility as possible – which leads to more opacity than transparency for investors. A classic example of this is the [August 2021 resolution from Eicher Motors Limited](#) seeking to reappointment and fix remuneration for Siddhartha Lal – it set a cap at 3% of profits without any other details or explanation. In the past, Siddharth Lal's remuneration had not exceeded 1.5% of profits, but without any disclosures or details, setting the cap at 3% of profits spooked investors. The [resolution was defeated](#) and when [the board came back for a shareholder approval in October 2021](#), it provided far greater clarity and capped the remuneration at 1.5% of profits – which was [eventually supported by shareholders](#).

Investors tend to vote in the hope that past practices will determine the future road map for executive compensation. But, there have been more than enough surprises with open-ended resolutions. For example, in 2019 HEG Limited's board agreed to pay the company's promoter and [Executive Chairperson a remuneration of a Rs. 1.2 bn](#) – this was (and continues to remain) the highest remuneration paid to an executive director (excluding ESOPs that are often paid-out handsomely) in the over 850 companies that IiAS tracks. One can argue that the remuneration paid out was within the terms approved by shareholders – upto 2.5% of profits as commission. But this is where the need to have a monetary cap (in absolute terms) on remuneration is needed. In 2019, HEG had benefitted from capturing the market vacuum created by the decline in steel exports by China and not by any change in their operating parameters. For factors completely outside their control, do CEOs merit such disproportionate rewards?

As Indian companies become increasingly global the NRC's need to benchmark their practices to global expectations. They need to focus on explaining the basis

What investors want to know

1. Structuring the compensation
2. Determining and disclosing performance metrics linked to variable pay
3. Factoring sustainability targets into performance measures
4. Stock option grants must align with investors' interests
5. Setting a cap on CEO remuneration
6. Having claw-back and malus built into the remuneration structure
7. Rationale for increasing pay mid-term
8. Finding the right peers to benchmark against
9. Better annual report disclosures on determinants of past pay

of CEO remuneration – which is tricky especially in the case of well-established long tenured and successful CEOs. These CEOs wield significant clout in the industry and loyalty among their clan, to a point where boards are reticent in establishing accountability. Several of these CEOs are members of the NRCs themselves, and however much companies reiterate their conflict-of-interest policy, there is a looming presence in the room – whether physical or not.

To create stronger governance structures for CEO pay, NRCs must focus on creating the right pay structure. These structures need to have a mix of fixed and variable pay (both long-term variable pay, usually in the form of stock options, and short-term variable pay usually in the form of annual performance bonus). While some companies have got the structure right, there continues to be reticence in putting CEO pay at risk – as a thumb rule, CEO pay tends to have about a 50% variable pay component, while globally this can range from 70% to 90%.

Even while variable pay structures are being created, NRCs rarely define the underlying performance targets that will drive variable pay. And, while companies continue to extol the virtues of their ESG initiatives, there are very few companies that have embedded ESG targets into executive pay. Cipla Limited, Infosys Limited and United Spirits Limited are among the handful in India while others like

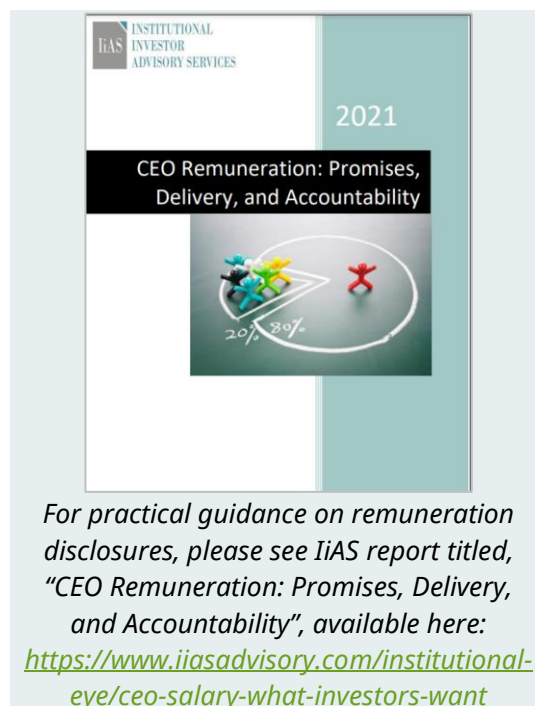
Unilever plc in UK, which has created a [Sustainability Progress Index](#) that forms a part of the long-term variable pay target for the company's leadership. Unilever plc's reports provide sufficient clarity on the tenets of executive pay – but the quality of disclosure is its antithesis for the Indian arm. For MNCs, this is par for

course – disclosure in global markets on executive pay provides far more clarity than those provided in the annual reports of their Indian subsidiaries.

With increased investor push bank on executive remuneration, NRCs must get themselves involved in the drafting of the remuneration resolutions and ensuring there is clarity regarding intent. Before that, they need to be mindful about how they benchmark executive remuneration. Most NRCs fail to create good benchmarks to establish CEO pay – if they did, remuneration levels would not be reaching new highs, as they do almost every AGM season. Spending time determining the right peers – companies that provide comparable performance metrics or poaching grounds – is critical.

The other practice that NRCs have resisted is clawbacks and malus. Because about two-third of listed companies in India continue to be family-owned, the general view is that controlling shareholder will bat for the long-term. However, this has belief has been disproven time and again. Having malus and clawbacks embedded into the remuneration structure will ensure that while the company chases growth, it also focusses on the quality of growth. Car companies or pharma companies will have stronger safety protocols, for example, to avoid product recalls. RBI has mandated clawback and malus for CEOs of banks – perhaps SEBI will consider enforcing this too.

The risk of continued excessive remuneration is prescriptive regulation. RBI has already brought in a guidance structure for CEO pay, and SEBI too may put such guidelines in place. A critical change will be to bring executive remuneration under the ambit of related party transactions. This will stop promoters from voting on their pay. And it will possibly be the quickest way to push NRCs to become more thoughtful and transparent.



Bloomberg | Quint

A modified version of this article written by Hetal Dalal was published on BloombergQuint; the article can be accessed here: <https://www.bloombergquint.com/opinion/hero-motocorp-eicher-to-heg-investors-seek-more-clarity-on-ceo-pay>

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