STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

AccountingWatch

Global Accounting and Governance Insights

December 2013

A Credit Perspective On Executive Compensation

Executive compensation, particularly for a company's CEO, has been, is, and likely will remain a matter of keen interest and debate for boards of directors, executive compensation advisers, investors, politicians, and the public at large. With the SEC seeking comment on a pay ratio disclosure for the CEO as a multiple of all other employee compensation (pursuant to s.953 (b) Dodd-Frank Wall Street Reform and Consumer Protection Act 2010), we take this opportunity to outline elements of Standard & Poor's Ratings Services' approach to the potential credit impact of an issuer's compensation programs.

Potential analytical impact and considerations:

- **Remember the Board of Directors' role:** Devising and executing issuers executive compensation programs is a key board responsibility. The discussion of pay in a company's proxy statement (Compensation Discussion and Analysis) provides one of the few windows into how the board incentivizes executives while managing the company's key risks. Compensation programs which promote outsize risk taking could indicate a board that is failing more broadly to exercise its oversight responsibilities on behalf of investors.
- **Investors have a voice – listen to it:** To date, shareholders have shown tolerance toward high executive pay, if company performance matches their expectations. Nevertheless, the shareholder perspective may not always align with creditors' interests and some 'say on pay' votes may reflect indifference rather than endorsement of a company's executive compensation program.
- **And when they vote – pay attention**: All the more reason when a vote on executive pay fails to gain majority support to examine pay size and components to see if it is an outlier compared with portfolio peers. Check too for votes against directors who are compensation committee members. Their failure to be re-elected could pose additional risk for the board's ability, going forward, to function effectively.
- **Pay ratio disclosure will likely provide a new window into compensation:** It will be a few years before these disclosures are a common component of the proxy cycle, and there is significant flexibility for companies to develop their own approach - making peer comparisons difficult. Nevertheless, they will provide another point of comparison for analysts to consider alongside 'total summary compensation' and similar disclosures and are bound to receive a great deal of attention from investors and the media.
- **Monitor pay trends rather than trying to reconcile different pay metrics:** Analysts should monitor CEO and median pay trends at rated issuers, no matter which metrics finally are employed. The reasons for a widening or a narrowing trend at a rated issuer need to be explored – widening is not necessarily 'bad', nor narrowing 'good' – or vice versa. As the workforce at many rated issuers becomes more diverse and decentralized, insights gained from pay ratio analytics will help to redefine elements of labor costs and address issues like recruitment, motivation and retention across the employee spectrum – all of which could impact our forward-looking view of the credit strength or challenges of the enterprise.

In the U.S., most publicly listed companies are required to give shareholders a nonbinding vote on the company's executive pay practices, joining others around the globe (e.g., Australia and the U.K.) In 2011, Australia put 'teeth' into say on pay. Two consecutive votes against the remuneration report can trigger a board re-election process. In other countries - Canada is one example - the prompting of institutional investors has resulted in approximately 80% of the country's biggest publicly traded companies embracing the practice. A large number perform this 'say on pay' exercise yearly during the annual shareholder meeting. These are closely watched by investors, the media, and other observers.
For the most part, these votes have been unproblematic for rated issuers, which is why failing to receive a majority of the votes cast deserve additional scrutiny. However, some shareholder measures of pay can

be based on performance measures which may not align well with the interests of creditors. Consequently, analysts should examine pay metrics to identify if an issuer's compensation program could be a driver of outsize risk taking, for example based purely on share price enhancement, or is an outlier when compared with its peers.

More broadly, the analysis of compensation which companies present in their proxy statements (DEF 14A) *Compensation Discussion and Analysis* (CD&A) have helped us to better assess the consistency of an issuer's strategy in the context of the marketplace conditions it confronts. How key leaders are incentivized provides significant evidence about the risk appetite of the board of directors and their approach to the company's key opportunities and risks. Analysts can compare the CD&A with the Management Discussion and Analysis (MD&A) in the company's annual report (10-K) to form an opinion about the alignment between these two important corporate disclosures.

Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers – 13 November 2012