Five Cornerstones for Successfully Embedding «Skin in the Game» in Executive Pay Strategy

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1. Introduction

Recent years have witnessed rising expectations by investors, proxy advisors and regulators on the interplay of executive pay and risk alignment, conduct-related matters, and sustainability. For example, the United States Securities and Exchange Commission (SEC) has included a mandatory clawback policy for listed companies. This is a concrete way to ensure executives have «Skin in the Game» and helps embed this important notion in pay strategy.

The renowned principal-agent theory builds on the assumption that ownership and control are being separated and that the agent (or executive) has an advantage in terms of information over the principal (or shareholder). From this context dating back to the 1970s, today's corporate governance models including compensation strategies have been developed. How can they be implemented effectively so the executive acts in the best interest of the shareholder? To get straight to the point: by embedding «Skin in the Game».

A closer look at «Skin in the Game» demonstrates its relevance through promoting an entrepreneurial mindset, setting measures to ensuring accountability of actions, allowing for participation, and supporting a positive external perception by different stakeholders. Among others, the most important questions include: What are effective measures to implement «Skin in the Game»? What is the current market situation and how has it developed over recent years? What are top considerations when designing «Skin in the Game» measures?

2. Five Cornerstones of «Skin in the Game»

These five cornerstones can be dealt with independently, either linked to pay or governed by regulations outside compensation matters, and/or also complementarily. For example, a shareholding requirement could be established regardless of the actual compensation framework.

Figure 1: Five cornerstones of «Skin in the Game»:

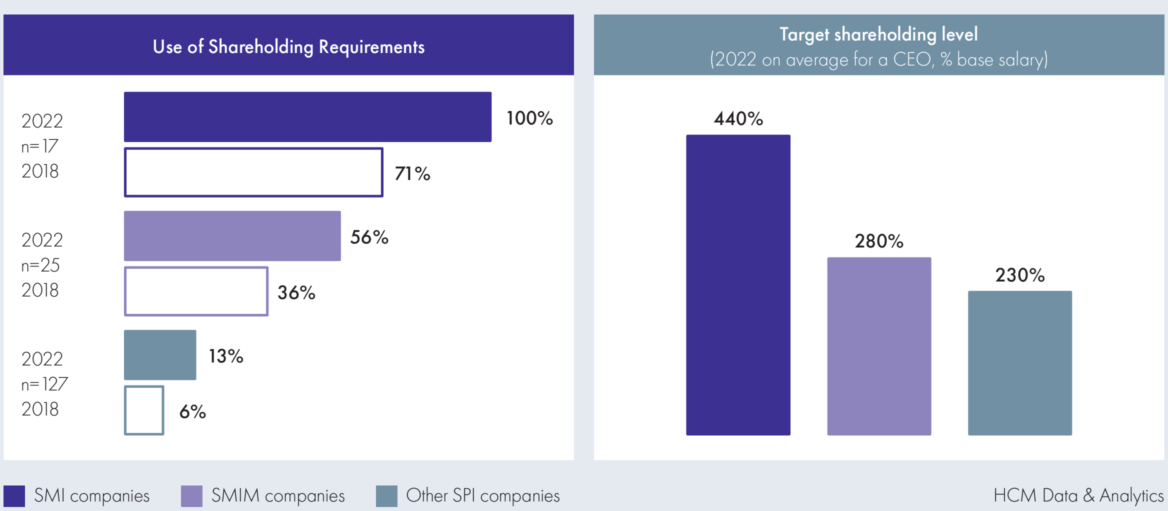
Shareholding Requirement	Mandatory holding of equity
Pay Duration	Time to reveive total direct compensation
Malus	Reduced compensation in case of underperformance
Forfeiture	Cancelling variable pay under certain circumstances
Clawback	Recouping already paid out compensation in certain cases

2.1. Shareholding Requirements

The first measure to embed «Skin in the Game» is to establish a Shareholding Requirement, i.e., a policy requiring an executive to accumulate and hold a certain amount of shares (often expressed in a multiplier of base salary or a number of shares) within a defined time period. The accumulation can be done by acquiring shares by own means or by keeping and not selling shares received as deferred compensation. One decision point is whether to count only shares which are fully owned or to also include unvested shares from deferred awards. In essence, the Shareholding Requirement increases the alignment of the executive's wealth to the interests of the shareholder.

In the market one can observe an increasing use of shareholding requirements between 2018 and 2022. All leading firms (SMI) in Switzerland have included Shareholding Requirements in 2022, up from 71% in 2018. The trend can also be seen in the SMIM companies where 56% made use of it in 2022, an increase of 20 p.p. from 2018. In smaller firms (Other SPI companies), the use of shareholding requirements was still lower, but doubled from 6% (2018) to 13% (2022).

Figure 2: Shareholding requirements use and target level for Swiss CEOs



In terms of the target amount (i.e., how many shares must the CEO accumulate), the range in 2022 for SPI companies on average went from 440% of the CEO base salary at SMI companies to 230% on average for Other SPI companies in 2022. The target level has remained stable since 2018 for SMIM companies at 260% on average of the CEO base salary while increasing for SMI (390% in 2018) and decreasing for Other SPI companies (250% in 2018). Typically, the build-up period for the CEO is 4.6 years on average, with a range of 3 to 5 years.

Should members of the Board of Directors (BoD) also be required to have Skin in the Game? There are two views: To be an «independent judge» a Board member should not have any financial stake in the company's performance. Or, to best represent the shareholders' interests, the Board member should have some personal financial exposure to the share price developments of the company, in effect sharing in the «shareholder experience». Market data confirms this split of views: Around 50% of SPI companies pay BoD fees partly in shares in 2022 (often between 20% to 50% of the total fee). As such shares are typically blocked but fully owned, this can be considered an implicit Shareholding Requirement. Explicit Shareholding Requirements for BoD are less prominent with only 11% of companies employing such a policy.

Applying Shareholding Requirements is the first step to increase «Skin in the Game», nonetheless, controls must be established. In case the requirement has not been met after the stated build up period, some mechanisms can be used, such as a holding lock for vesting shares from long-term incentive plans (LTI).

2.2. Pay Duration

Even though Shareholding Requirements have gained significant momentum and expose (part of) executives' wealth to shareholder experience, other forms of alignment are found in the structure of executive's compensation frameworks. Particularly, this concerns deferred compensation schemes, including forward-looking LTI plans.

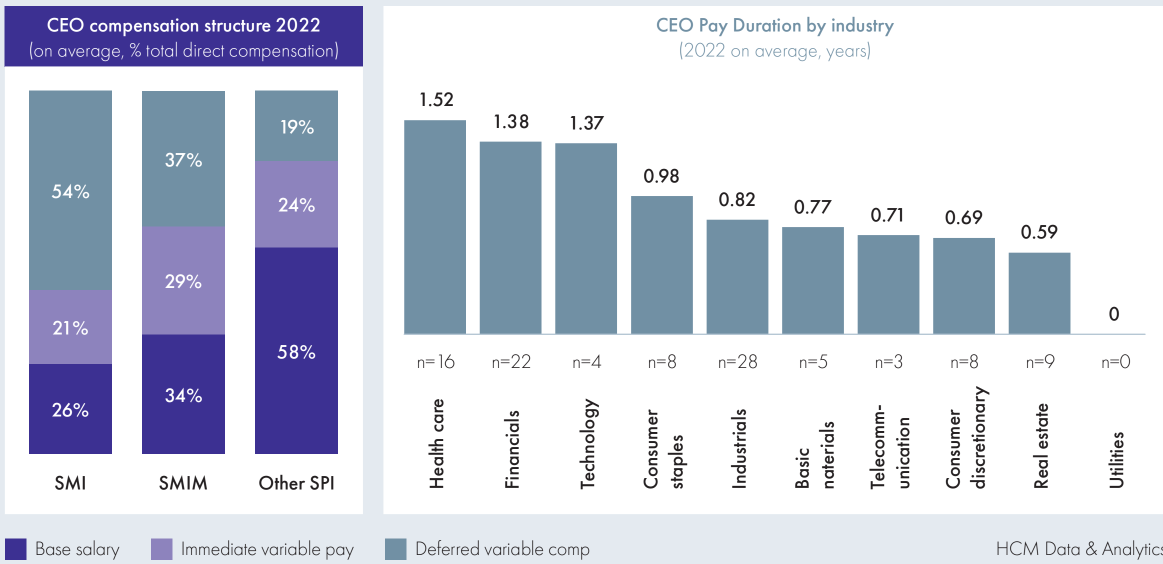
When designing an LTI to embed «Skin in the Game», two factors are important: time (how long should the period be until vesting?) and structure (how much of the total pay package should be delivered later vs. immediately?). The longer the period and the larger the deferred compensation included in the compensation package, the more «Skin the Game» and thus the greater opportunity to hold executives accountable. The weighted average of time and structure is the so called «Pay Duration».

For example: An executive's pay package which includes a base salary and an immediate cash award without any deferred compensation has a Pay Duration of 0 years. Once a deferred element is added, duration increases. Say an executive has 100 as base salary, 100 as immediate cash award and 100 as an equity grant which is deferred over 3 years, then the package's Pay Duration is 1 year (0x33%+0x33%+3x33%).

For compensation structure, market practice indicates that larger companies have more deferred compensation. For SMI companies, deferred compensation represents up to 54% of CEO total direct compensation on average. SMIM companies defer 37% of CEOs' pay and Other SPI companies 18% on average. Hence, the Pay Duration of executive pay packages very much depends on the size of the company (see also graph in Section 2.3).

On the other hand, Pay Duration also varies depending on industry. The highest Pay Duration is found for CEOs in the Health Care industry with an average of 1.52 years, whereas the average of all SPI companies is close to one year.

Figure 3: Compensation structure and pay duration for Swiss CEOs



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2.3. Malus

A Malus applies when deferred compensation is reduced in part or totally due to the non- or under-achievement of quantitative and/or qualitative performance targets. The relevant measure could be, for example, not having any regulatory investigations or fines or not meeting some minimum financial performance hurdle. In other words, Malus brings performance risk into a compensation package.

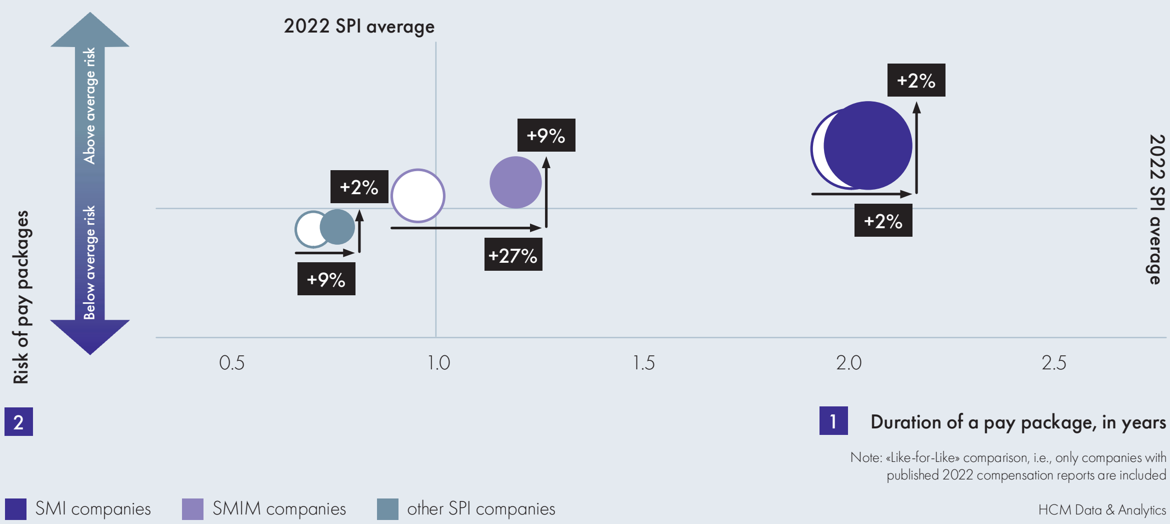
In terms of the nature of the performance targets in deferred plans, 87% are financial and 13% are non-financials, including ESG. In fact, companies are increasingly using ESG-related KPIs. For example, for SPI companies, the number of companies linking long-term performance conditions to ESG has doubled from 2018 to 2022.

The graph below combines Pay Duration and Malus. Naturally, both measures are correlated: where there is a longer Pay Duration there is also more risk given pay is deferred and subject to future outcome. For example, a blocked share award over 3 years exposes the participant to lower risk than a performance share unit grant subject to underlying equity performance, relative share price performance, and other operating performance indicators, in addition to the possibility of losing the award in case the employment ends before vesting, i.e., Forfeiture (see Section 2.4).

The graph, which compares 2018 and 2022, shows that the size of a company, again, affects the Pay Duration and risk of the pay package, but overall, it increased among all companies. On average, duration for SMI companies was 2.0 years (+ 2%), 1.2 years (+27%) for SMIM companies and 0.7 years (+9%) for Other SPI companies.

Over the last five years, both the Pay Duration and the risk pay package has increased on average for large and also smaller firms. However, it is in the nature of larger pay packages that they carry more risk and also take longer to become realizable.

Figure 4: Development of risk of pay packages and pay duration of CEO pay packages 2018 to 2022



2.4. Forfeiture

As noted above, Forfeiture is a design measure of compensation which cancels an award or prevents vesting, partly or totally, of the amount of deferred compensation in certain circumstances. This can include conduct conditions or the termination of employment.

Forfeiture is a broadly used measure in the market. Forfeiture clauses were present on average at 80% of all SPI companies in 2022. Among SMI companies all had had Forfeiture clauses for their long-term plans in 2020, though it decreased to 95% in 2022 Other SPI companies have steadily increased (43% in 2019 to 55% in 2022) and SMIM companies remained slightly below the SMI companies at around 90% in 2022.

Forfeiture clauses are not necessarily applied to all compensation plans of a company and the application also differs between companies. In the relevant plans, the application of Forfeiture will vary depending on the type of compensation (e.g. blocked, restricted or performance-based etc.). Some companies apply it to all share-based awards but not to cash, while others foresee it for all kinds of deferred awards. Some events in which compensation elements are forfeited include certain specificities in termination of employment, a change of control, misconduct or financial restatements.

2.5. Clawback

A Clawback is a mechanism to reclaim vested and/or paid out compensation awards that are already in the ownership of a beneficiary. They are an effective element for embedding «Skin in the Game» in an executive pay package. While part of the regulatory regime in other countries, Clawbacks are controversially discussed in Switzerland, especially in the banking context.

Still, around 82% of SMI companies included a Clawback in 2022, an increase of 17 p.p. since 2018. The increased prevalence of Clawbacks in SMIM and Other SPI companies also confirms the growing importance of this mechanism (24% and 6% in 2018 compared to 52% and 19% in 2022). Evidently, larger companies are at the forefront with regard to Clawbacks, potentially because they are in the spotlight and under public scrutiny to follow best governance practices.

Data shows that Clawbacks are applied either to the entire variable compensation (46% of Clawbacks), or solely to certain elements (18% for short-term, 37% for long term elements). They usually enable the reclaiming of relevant compensation for up to three years if certain trigger events occur, e.g., misconduct (61 % of companies with disclosed Clawbacks), illegal activities (54%), and financial restatements (49%).

Figure 5: Overview of clawback use in Swiss companies

Although there is some legal uncertainty on the enforcement of Clawbacks, this does not mean that they are not effective per se. Indeed, the effectiveness of a Clawback could be deemed to be most effective due to its preventive character, i.e., it creates an incentive for the executive to avoid the trigger event. A Clawback could also be understood as a signal to employees about the kind of conduct and risk-aligned behavior that is expected by the company. The low number of cases of (public) enforcement might suggest they are having this kind of a positive preventive impact.

Clawbacks have been rolled out in other jurisdictions for more than a decade. In the UK for example, financial services companies are required to implement Clawbacks for risk taking functions for seven years following the grant and up to ten years in case of ongoing investigation. And recently, the SEC made Clawbacks compulsory for all listed companies following «restatements due to material noncompliance», for a three year look back period from the event happening. Further, Clawbacks are generally well perceived by proxy advisors.

3. Conclusion

«Skin in the Game» is an important consideration when assessing executives' pay packages. This article presented five cornerstones having growing market prevalence for increasing «Skin in the Game»:

Although the specifics of the measures are diverse, they serve the same purpose in giving executives a relevant and tangible stake in the company's performance and align their interest with the shareholders' experience. In terms of implementation, they have to be designed carefully, monitored, and observed. Here the Board Compensation Committee plays an important role.

The data shows that many firms make use of these measures, with differences mainly stemming from company size, which is also a main driver for the level of executive pay. Overall, the data supports what one would expect: The larger a company, the more the «Skin in the Game», i.e., the larger the pay package, the more risk is embedded and the longer it takes to realize such pay.

While «Skin in the Game» is essential, there are other important objectives of a compensation framework. The primary drivers of compensation design should be the culture and strategy of the company to anchor the ambitions, values and desired behaviors, thereby promoting a more sustainable development and value creation.