Western European Executive Pay Disclosure Trends Bode Well For Better Credit Analysis

Summary

Executive compensation can affect credit quality in a number of ways: it influences senior management’s behavior; it affects a company’s ability to retain and attract top talent; it can highlight weak boards or poor decision-making; and it can promote strategies that promote higher levels of credit risk. For these reasons, analyzing executive pay is an important element of corporate governance analysis, which is a factor in assigning a firm’s credit rating.1

In this context, investors benefit from positive trends in Western Europe towards better disclosure of executive pay. The quality of pay disclosure in Western Europe varies significantly, which impedes the ability of investors and analysts to interpret potential implications of pay for bondholders. However, regulatory reforms, at the European Commission and country levels, are closing the disclosure gaps. The reforms reflect the fact that the intensity of investor, media, regulatory and political scrutiny of pay has increased significantly in recent years in Western Europe, as it has in the US.

This Special Comment outlines why pay analysis matters for investors, outlines how disclosure practices differ across Western Europe, and describes trends towards improved disclosure.

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1 Moody’s has outlined its overall approach to analyzing executive pay in its Special Comment, U.S. Executive Pay Structure and Metrics, June 2006 (97887). Despite its title, the report has broad applicability.
Executive Compensation Is Important To Credit Quality

Moody’s research has found a relationship between outlier CEO pay and an increased level of subsequent realized credit risk. Even in cases where a firm’s pay is broadly in line with that of its peers, it can affect credit quality in three ways:

1. **Compensation influences senior management’s behavior.** Managers of corporations have broad powers and a wide range of discretion. Boards typically offer managers substantial and elaborate financial incentives (particularly in the US) to encourage certain priorities and types of behavior, which may or may not be beneficial from a credit quality standpoint.

2. **Compensation policies affect executive recruitment and retention.** The interests of both shareholders and bondholders can be harmed by executive remuneration policies that fail to attract and retain effective leadership.

3. **Compensation practices provide visibility into (a) the overall quality of governance and (b) the management-board relationship.** Pay practices can provide some visibility into the relationship between the board of directors and senior management, and on whether management is, in fact, accountable to the board. Outlier pay can signal a weak board.

For these reasons, analyzing executive pay is an important element of corporate governance analysis, which is a factor in assigning a firm’s credit rating.

Pay Disclosures Vary Significantly

The quality of executive pay disclosure varies greatly across Europe. To a great extent, the variety reflects the regulatory approach in each market, as noted below. Some countries set legal requirements for what must be disclosed; some countries use a best practice approach based on the “comply or explain” principle (whereby listed companies have to comply with the best practices or explain publicly why they have chosen not to do so); other countries set no or very limited requirements. Regardless, the variety of standards inhibits systematic analysis of executive pay in two broad areas: (1) overall pay philosophy and (2) actual pay awards:

1. **Description of pay philosophy and major pay components.** Generally, pay disclosure practices for issuers in Western European countries, in terms of boards describing their pay philosophy and rationale for key components of pay (such as the annual bonus and long-term incentives) in public disclosures, fall into three categories: (i) disclosed by all companies, (ii) disclosed by some companies, or (iii) not disclosed at all (see Table 1 for disclosure practices for a selected group of Western European countries).

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2 In a 2005 study, CEO Compensation and Credit Risk, (July 2005, 93592), Moody’s found an empirical relationship between (1) outliers that pay the CEO very high levels of bonus and stock option pay in comparison with peers and (2) subsequent realized credit risk. While the study did not demonstrate causation, we believe that a likely factor in this linkage is the degree to which unusually high executive pay can reflect weak board oversight. Excessive pay can also promote riskier strategies.

3 It is important to note that shareholders and creditors are likely to have different views on optimal pay structure due to their differing risk appetites and financial requirements. In Moody’s corporate governance analysis of rated companies, we take a long-term bondholder viewpoint, and comment favorably on pay structures that promote a disciplined attitude about leverage and discourage risky, short-term strategies highly focused on share price.

4 By “board”, Moody’s typically refers to the board of directors. In those jurisdictions with a dual board structure, we refer to the role of the supervisory board.

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### Table 1: Typical Level of Disclosure of Pay Philosophy, by Country

<table>
<thead>
<tr>
<th>Description of:</th>
<th>Denmark</th>
<th>Finland</th>
<th>France</th>
<th>Germany</th>
<th>Ireland</th>
<th>Italy</th>
<th>Netherlands</th>
<th>Norway</th>
<th>Portugal</th>
<th>Spain</th>
<th>Sweden</th>
<th>Switzerland</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay philosophy, bonus, long-term incentives</td>
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<td>Pensions</td>
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<td>Severance plans/payouts</td>
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<tr>
<td>Pay peer group</td>
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<td>Performance metrics</td>
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</tbody>
</table>

1 Disclosure of the pay philosophy is not required in Norway.
Source: Mercer LLC, Executive Compensation Disclosure in Europe, 2007; Moody’s research

As can be seen in Table 1, one of the areas on which there is some variety between Western European countries is the degree to which companies provide detailed descriptions of pensions and severance entitlements for senior executives, and there is even more variety with regard to the disclosure of each company’s chosen performance pay metrics and pay peer groups.

2. Disclosure of actual pay awards. As shown in Table 2, each of the Western European countries requires the disclosure of pay awards in one of the following three ways:

1) The compensation for each executive officer (e.g. the top five executives);

2) Individual pay totals for the CEO or highest-paid executive only, and an aggregate total for the remainder of the executive group; or

3) A lump-sum total for the executive group as a whole.
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Table 2: Typical Type of Pay Award Disclosure, by Country

<table>
<thead>
<tr>
<th>Disclosure of:</th>
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<th>Spain</th>
<th>Sweden</th>
<th>Switzerland</th>
<th>UK</th>
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</thead>
<tbody>
<tr>
<td>Individual executives' pay (total, components)</td>
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<td>✔️</td>
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<td>✔️</td>
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<td>Individual breakdown for CEO or highest paid executive and aggregate pay total for other executives as a group</td>
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<td>✔️</td>
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<tr>
<td>Pay total for executive group provided only in aggregate</td>
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<td>✔️</td>
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</tr>
</tbody>
</table>

Source: Mercer LLC, Executive Compensation Disclosure in Europe, 2007; Moody’s research

All of those countries requiring disclosure of individuals’ pay require supporting detail on the amounts paid in salary, annual bonuses and long-term incentives. All of these countries also require disclosure of other benefits (with the exception of Germany) and pensions (with the exception of Italy and Switzerland).

Some large, widely held multinationals with multiple stock exchange listings, e.g. in New York or London, may choose to disclose more than is required by local laws or corporate governance “best practice” standards; however, the percentage of companies doing so is relatively small.6

Moody’s Requirements for Detailed Pay Analysis

Moody's views the following questions as “must haves” in gaining an understanding of a company’s pay practices:

- What is the underlying philosophy driving the pay structures and decisions?
- What is the overall structure of pay, i.e. what is the breakdown between short-term and long-term elements of pay?
- What is the overall magnitude of pay and its components?
- What are the key performance metrics used in both annual bonuses and long-term incentive plans?

For further discussion of how Moody’s analyzes pay from a bondholder perspective, see Moody’s Special Comment, U.S. Executive Pay Structure and Metrics, June 2006.

Regulatory Reforms Are Enabling Better, More Uniform Disclosure

Despite significant disparities in pay disclosure practices, the regulatory push underway for better, more uniform disclosure will benefit investors in Western European companies who want to analyze executive pay more thoroughly. The regulatory push has a number of drivers.

The intensity of investor, media, regulatory and political scrutiny of pay has increased significantly in recent years in Western Europe, as it has in the US. Shareholders are calling for closer links between pay and corporate performance, and more rigorous, independent board monitoring of compensation. Investors also

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6 For example, a July 2006 study, the U.K. proxy voting firm Manifest (“Directors’ Remuneration, A Pan-European Perspective”) reviewed 117 European companies that filed an annual report on form 20-F with the U.S. Securities and Exchange Commission (SEC). Approximately 7% of these companies disclosed more information in the 20-F than was required by local market standards. In most cases the companies provided additional disclosure on individual executives’ pay and equity-based incentives.
want a greater voice in compensation-setting around the world, most visibly in their “say on pay” campaign: four countries (Norway, Sweden, the Netherlands and the UK) already allow shareholders an advisory or binding vote on the company’s executive pay report. Beginning in 2009, investors in listed French companies will have a binding vote on severance packages for chairmen, CEOs and deputy CEOs. There is also growing momentum in Switzerland to give shareholders a voice on executive pay.

At the same time, a number of high-profile pay scandals – in particular, those involving excessive severance payouts (so-called “golden parachutes”) despite weak performance – have attracted media attention and, in some cases, fueled public and political outcry over executive pay.

In response, European policymakers have taken steps to improve pay disclosure:

- **European Commission recommendations:** The EU Commission stated, in a 2004 report, that executive pay was a prominent feature in many of the corporate scandals in the earlier part of the decade. The report cited pay scandals at Vivendi and Skandia, among others, as examples of pay incentives causing poor behavior. In order to improve management accountability to shareholders and increase the transparency of pay practices, the Commission recommended changes, including enhanced pay disclosure (see sidebar).

  Rather than mandate a “one size fits all” approach, the Commission left it to individual member states to apply the non-binding principles by June 30, 2006, through legislation or through best practice rules based on the “comply or explain” principle. Member states have implemented the proposals to varying degrees. The Commission continues to monitor implementation and has highlighted that it will recommend additional reforms, if required.

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**European Commission Compensation Recommendations**

The European Commission recommended that member states adopt measures to enhance pay disclosure and shareholders’ power of pay decisions:

**Disclosure:**

1. *Compensation policy and major components of pay.* Companies should publish a statement on compensation policy for the following year, including a breakdown of fixed and variable compensation, performance criteria and the parameters for annual bonus schemes or non-cash benefits.

2. *Individual executives’ compensation packages.* Such disclosure should include information on equity compensations, such as stock options, company contributions to pension schemes and any loans or guarantees to executives.

**Shareholder rights:**

1. *Shareholders’ vote on compensation policy.* Companies should submit the compensation policy to an annual vote, which may be either binding or advisory. Such a vote allows shareholders to exert influence on compensation and encourages shareholder-management dialogue on compensation policies.

2. *Prior shareholder approval of share plans.* Any variable incentive plans where executives receive shares or stock options should be put to a vote of the annual meeting. Shareholders should vote on the details of the share plan, not individual awards.

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7 Commission Recommendation on Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies, October 2004. By “Directors”, the Commission is referring to the company’s top executives.
Country-level reforms: There have been a number of changes at the country level in response to the Commission’s recommendations. For example, Italian companies are now legally required to disclose details of pay philosophy, performance plans and long-term incentive values and criteria. Swedish companies have been providing more detail on bonus and long-term incentive plans, perquisites, severance arrangements, and other pay details in response to a new governance code that took effect in 2005. Looking forward, Swiss companies will be required to disclose additional information about CEO compensation beginning in 2008.

Investors can expect pay disclosure to improve further in coming years, but at different speeds in each country. The pace will be determined, in part, by the level of public and political concern about high pay, often driven by problems at high-profile local companies. Improvements in disclosure requirements within a country tend to come in waves:

- First, companies are required to disclose the details of individuals’ pay (both totals and their components) and the philosophy underpinning pay structures and payouts. Without such disclosure, investors are unable to undertake basic analysis of executive pay.

- Second, companies are required to disclose details of executive pension plans and accrued pension entitlements, in part to address investor concerns about so-called “hidden pay”.

- Third, regulators require the disclosure of performance metrics used by the board in determining payouts and the group of peer companies used in pay analysis. Very few countries mandate adequate disclosure of metrics and peers, which impedes investors’ understanding of the links between pay and company performance.

In individual countries, pay scandals surrounding large payouts to departing executives will, no doubt, necessitate more detailed disclosure of severance plans and payouts, but this tends to happen regardless of how advanced the country’s overall pay disclosures are relative to other countries.

Investors can expect regulators to take a more aggressive approach to ensuring compliance with local pay disclosure standards. In response to non-compliance with voluntary best practice codes, regulators in many countries are choosing to legally require disclosures or incorporate comply-or-explain governance codes into stock exchange listing rules. For example, Germany now legally requires listed companies to disclose individual executive pay awards, after it became apparent that too few companies made appropriate disclosures in response to the country’s voluntary comply-or-explain code.
Moody’s Related Research

Special Comments:

- U.S. Directors May Have To Confront Investor Demands to Rethink Executive Pay, January 2007 (101676)
- Update: 11 Issuers See Rating Actions Linked to Option Timing Probes, November 2006 (100524)
- Stock Option-Timing: Scrutiny and Risks Increase, July 2006 (98494)
- U.S. Executive Pay Structure and Metrics, June 2006 (97887)
- Stock Options “Backdating”, June 2006 (97760)
- The Downside of Incentive Pay for Directors, April 2006 (97174)
- CEO Compensation and Credit Risk, July 2005 (93592)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
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Author(s)  Editor  Production Specialist
Christian Plath  Mark Watson  Yelena Ponirovskaya